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Illinois Society of Certified Public Accountants

PRESIDENT'S PAGE

Over the past several years a great deal has been written about the relations between lawyers and certified public accountants. Some of the statements made on behalf of the legal profession have either implied or contended that, in their tax work, CPAs are prone to engage in the unauthorized practice of law. We are all familiar with the several court cases that have involved this issue. In making these comments, it is my wish only to express some thoughts to CPAs about their relations with lawyers.

One of the happier thoughts about relations between lawyers and CPAs is that on an individual basis these relations are usually very good. I am sure that my experience is the same as most other CPAs; working a great deal with lawyers, we respect and appreciate each other and our association is most enjoyable. The only conclusion that can be drawn from this situation is that the lawyers with whom we work closely must not be truly representative of the organized bar.

The mutual objective of both professions most certainly should be the best possible service to common clients. If this objective is to be attained, there is no place for jealousy or pettiness between the two professions. Close co-operation is essential to the professional service our clients have the right to expect.

Contracts and other agreements often provide that computations necessary to effect their purpose be made by a CPA. Many lawyers will seek the comments of the client's CPA on proposed documents of this type. This is a logical course to follow in providing the best service to mutual clients. Lawyers can be encouraged to act in this fashion and it is entirely appropriate for the CPA to suggest, if not request, that he be afforded the opportunity of reviewing drafts of these documents with which he will necessarily work in the future.

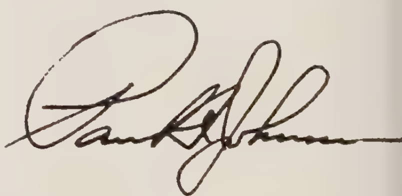
The lawyer may be a director or even an officer of the client and may in fact be the only one who can offer clear explanations of particular transactions. As a part of the audit, the CPA will want to discuss the status of any pending or threatened litigation with the lawyer. The examination of the client's financial statements may be expedited through good communications between the lawyer and the CPA.

Tax practice seems to be the particular area where some lawyers and CPA's feel that they must be on

guard in their relations with each other. There are, no doubt, situations where such a feeling on the part of each professional man is justified, yet here as in other areas the client will profit by close co-operation between his advisers. Who will assume primary responsibility for the handling of the matter through administrative consideration by the Internal Revenue Service will probably depend upon who is best qualified by experience in tax matters, whether lawyer or CPA. Many lawyers have had little experience in tax matters and are happy to have the CPA "carry the ball." When and if the matter progresses to the point of Tax Court or other court action, the client's lawyer, or more likely a lawyer specializing in tax matters, will assume the leading role. At this state of the proceeding, the CPA can be very helpful in the preparation of the case.

If the CPA is to merit the respect of lawyers—as well as his clients and the public—he must be professionally competent, articulate, and well-informed. If he commands this respect, the probability of good working relations with lawyers will be increased. Client relations also enter this area, since the lawyer often takes his cue from the client; if the CPA's relations with his client are on a solid basis, chances are the lawyer will be co-operative.

Both the CPA and the lawyer are in practice to render a truly professional service to their clients, and the client is best served by close co-operation between them. Continuing efforts are being made to effect co-operation through committees of the respective organizations, but the best place for both professions to start co-operating is in the rendering of service to their mutual clients. I have no desire to be an impractical idealist, but I strongly believe that widespread co-operation at the working level will practically eliminate the alleged problems between the two professions. Let us as individual CPAs do our part to achieve co-operation with individual lawyers.



NEW VISTAS IN ACCOUNTING

By Lloyd Morey

Accounting has been described as "a field of professional endeavor which concerns itself with recording, classifying, and analyzing financial data of business enterprises and formulating them into reports."[1] In view of the rapid and extensive expansion of the demands on accounting in the past few decades, it seems appropriate to review briefly the directions and nature of this growth and its implications for the future.

Growing Dependence of Business and Government Upon Accounting

The century in which we are living has witnessed tremendous changes in the methods and scope of business operations of all kinds. It has also produced a gigantic widening in the operations and the cost of government. There have been substantial changes in social as well as business philosophy.

To attempt to recount all the many illustrations of this statement would be to write an economic and business history of the past three decades. Not only have both business and government, at all levels, grown in size, extent and volume, but they have acquired new features and relationships. They have expanded both outward and upward in all directions. Many new avenues of business have come into being to deal with new products which have in a short time become the accepted requirements of our magnificent society in its quest for a constantly higher standard of living. Things that were undreamed a generation ago have become commonplace in less than a life span.

Financial services needed to cope with demands for funds for both personal and business needs have been expanded in number and character. Means and extent of transportation and communication have greatly increased. Business has become more and more public and less and less personal in ownership. The extent of financing through and ownership by the general public is evidenced by the greatly increased volume of security operations through public exchanges. These have meant closer regulation by government.

Government has entered into the finances of almost every citizen and of every business enterprise. It has also taken on many added activities itself, and its fundamental activities of national welfare have grown unbelievably, with no present indication of diminishment.

These and countless other develop-

[1] Dean Paul Garner, School of Commerce and Business Administration, University of Alabama, in "Education for Opportunities in Accounting," 1958.

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ments which could be catalogued have put greater and greater demands on accounting in its various phases. Not only have the volume and complexity of recording of transactions been greatly increased, but the reliance on both internal and independent accounting services for assistance in effective control of operations has steadily grown. The need for independent verification and certification has not diminished in extent or importance, but on the contrary has also spread. To these internal and external demands have been added the calls for assistance in devising and installing systems, efficiency studies, assistance in mergers and reorganizations, and above all, responsible aid in income tax matters. Thus the demands on accountancy have grown from a reasonably simple problem of recording, followed by a reasonably confined plan of independent verification, to a highly technical record and analysis problem, supporting a comprehensive internal system of control and reporting, and heading up in an independent appraisal and certification in the form of professional opinions.

The transformation of accounting from pure record-keeping and verification to its present breadth is itself truly a major phenomenon. This has come to pass in less than a century of time. It represents a major change in the character and extent of accounting work and a major shift in its emphasis.

The profession has met these heavier responsibilities and demands in an increasingly strong and forceful manner. To say that they have been and are now all being perfectly met would be quite unjustified, yet the progress and improvement have been such as to give us all a sense of pride and the business community a substantial sense of security and satisfaction. It is well to take stock, however, of the actual extent of this advancement.

Emergence of Accounting As a Profession

Accounting in its various aspects—record keeping, control, verification, guidance—enters into every business and every business transaction, public and private. Although accounting in its most elementary form, recording of financial transactions, is recognizable nearly 5000 years ago, its broad development is limited to the past 100 years. Only in that time has it begun to take on professional aspects. In America this character has been evident only in the past 75 years, and the major advancement has taken place in the past quarter century.

The earliest evidence of a trend toward the professional realm for accountancy took the form of *verification* of financial transactions and results of operation by persons of competence outside the business itself. From this there developed two important qualities: *independence* and *reliability*. These continue to be important qualities essential in the work of the profession.

But mere verification of itself does not form the foundation for a broadly professional service, however independent and reliable it may be. Dean Roscoe Pound reminds us that a *profession* involves the practice of "a learned art." To what degree has this been achieved in accountancy?

There are many "definitions" of a profession. The Commission on Standards of Education and Experience for Certified Public Accountants has recently set forth the following as

representing the essential characteristics: [2]

1. A body of specialized knowledge.
2. A recognized educational program for acquiring the requisite specialized knowledge.
3. A standard of professional qualifications governing admission to the profession.
4. A standard of conduct governing the relationship of the practitioner with clients, colleagues, and the public.
5. Formal recognition of status.
6. An acceptance of the social responsibility inherent in an occupation endowed with public interest.
7. An organization devoted to the advancement of the social obligation, as distinct from the economic interest, of the group.''

How fully does accounting now measure up to these standards? American Institute Executive Director John L. Carey concludes that the *certified* accountants of the country meet all of these requirements.[3] But it is well to check the record.

1. Certainly great progress has been made in the past few decades in the development of a body of literature which is invaluable for reference. What is still lacking to a considerable extent is a clear body of *principles*, developed by competent and representative authorities, and given *recognition by the profession.*

In spite of the wide use of the term in audit certificates, there is in fact no general agreement as to the exact meaning of the expression ''in accordance with generally accepted accounting principles.''[4] Nowhere can one find a codification of such principles which has been confirmed by a professional body.

Standards of auditing are more firmly stated and definitely affirmed than those of accounting. But even these are so general as to lack the scope and completeness needed for an authoritative guide.[5]

The picture is in some respects brighter with respect to the specific principles applicable to areas other than privately-owned for-profit enterprises: e.g., governmental and institutional. In most of these the development of basic principles and standards, in many ways identical but necessarily different in some respects from those of private business, has been carried out more positively and comprehensively than in the latter.

Notable among these are municipalities and universities, and now more lately, the federal government. This greatest of all business enterprises, after over a century and a half of working under methods grossly incomplete and inadequate, has finally been aroused by the efforts of Institute committees, Hoover Commissions and public interest. Principles have been established, programs are being developed, and substantial implementation has already taken place and more is in prospect.

Mention may also be made of progress in state government procedures. A notable example is Illinois where, goaded by a tragic experience of a serious defalcation of a high official due partly to inadequate fiscal controls, new features have been intro-

[2] University of Michigan Press, 1956.
[3] "The Place of the CPA in Contemporary Society," *Journal of Accountancy*, September, 1958.
[4] See Leonard Spacek "Challenge to Public Accounting," *Harvard Business Review*, May–June, 1958, reviewed by Robert I. Dickey in August, 1958 *Journal of Accountancy*.
[5] See Robert K. Mautz, "A Critical Look at Generally Accepted Auditing Standards," *The Illinois CPA*, Autumn 1958.

duced based on sound concepts of appropriate distribution of responsibility, adequate internal check, and comprehensive independent audit. In other local governments the situation is varied, with some favorable areas but many needing further improvement. In hospitals, considerable effort is being directed toward development of basic principles but their general acceptance has not yet been accomplished. This may be due in part to the variety of conditions under which hospitals operate, in part to the questionable validity of some of the proposed procedures, and to a changing philosophy of hospital public relations.

Qualified accountants and the profession in general have taken a much more active hand in these matters in recent years than formerly. This is especially true in Illinois and in the federal reorganization. Large opportunity still exists for professional interest and activity in this great area.

2. Great strides have been made toward providing an *adequate educational program* through academic training as a prelude to accounting practice. Good as much of this training is, it is still largely weighted on the vocational side. Yet no person is adequately prepared for really professional service if he has only a technical education. This needs to be supplemented by a broader acquaintance with the liberal arts and with behavioral subjects, so that the individual is prepared to present his material effectively and deal with people intelligently and convincingly. Otherwise he remains primarily a skilled workman rather than a professional person.

Among the more encouraging signs of an improved educational basis for accounting are (1) opportunity for advanced study beyond the baccalaureate level, and (2) development of research in accounting, both in institutions and in the profession. Advanced study and research are interrelated. Both contribute to the broadening of the academic foundation for the profession and toward making it a "learned art." But more intensive attention needs to be given to these areas, especially in the field of research. Encouragement of superior scholarship is an important element in this picture, including financial scholarship and interest in its development.

A dissenting opinion in the Commission's report states that "ours is a 'practicing' not an academic profession." This is only partially correct. It is true that in many areas admittance to the CPA examination is possible without collegiate academic training. It is also true that CPA examinations do not include tests of proficiency in the use of English, in public speaking, in economics, or a host of areas in which knowledge and competence are essential to the successful practitioner. Here is a deficiency needing correction. Ours can not be truly a profession unless it is based on learning in addition to technical knowledge; and a learned profession is founded on academic preparation, which is only possible to its full extent through college experience.

3. The next criterion of a profession deals with *standards of entrance* for admission to it. These have been well developed through the uniform American Institute examination, now used in all states. It constitutes generally a good test of understanding as to the technical aspects of accounting work. In my opinion, in view of the growing demand on accountants for service in governmental, educa-

tional, and other public service areas, and the special conditions in those areas, required questions in them ought to be regularly included in the examinations.

But passing the CPA examination, important as it is, does not, in most states constitute the right to *practice* accounting publicly and independently; actual experience in public accounting work under competent supervision usually is required in addition. The CPA certificate is, in fact, a certificate of proficiency in accounting, rather than a license to practice. In this sense, it corresponds to the M.D. degree in medicine, which is required for practice but does not admit one until he has passed the necessary internship in practical experience.

Many who become CPAs do not enter public practice. They go into other accounting activities in business, government, and institutions, many of them highly responsible. The CPA certificate is equally valuable to such persons, and by its possession they do qualify for membership in the profession. But so many people are engaged in accounting beyond the elementary range of bookkeeping who are not CPAs. In fact, only 58,000 of the 376,000 persons classified as accountants in the last federal census are CPAs. Many of these persons hold themselves out to render important public services. The public discrimination between certified accountants and others is growing but it is not universal. This continues to pose a problem of professional standards which is important. It also presents a challenge to both education and the profession to broaden CPA coverage of accounting service.

There are, of course, organizations of accountants other than the American Institute of CPAs, the American Accounting Association, the National Association of Accountants (formerly National Association of Cost Accountants), the Controller's Institute, the Institute of Internal Auditors, and others. All of these render good service, and all promote good standards. But none have the legal standing of the CPA.

4. Another highly important earmark of a profession is its ability and its willingness to establish and apply *standards of conduct* between its members and in the relations of its members with the public. The American Institute and the state CPA societies have given strong emphasis to this obligation and with marked success. The tenets of ethics advanced by the profession through these channels are accepted by its membership and generally followed. Violations are dealt with substantial thoroughness. However, as above noted, many accountants rendering public services, some of whom are licensed to do so but in classifications other than "certified," are not members of professional bodies, and hence do not formally subscribe to and are not bound by such restrictions. Furthermore, only about 60% of the CPAs of the country are members of the American Institute. Hence there is a considerable void in the application and enforcement of standards of conduct which may be detrimental both professionally and publicly.

5. The next standard of a profession—*formal recognition of status*—has been achieved, in somewhat varying forms but substantially identical, in all the states.

6. Recognition by the profession of the *social responsibility* of its members to the public is established, among other things, by emphasis on

the independence of the public accountant when serving as auditor, separating him from participation in the management of the organization which is reporting to the public or to the stockholders.

7. Finally, great praise can be given for the advancement in size, service, and influence of the *accounting organizations* of the country, both national and state. Yet we need to recognize unfilled gaps in this picture. Mr. Arthur B. Tourtellot, public relations counsellor engaged by the American Institute to review its public relations status, in a report distributed in June, 1956, observed: [6]

> "The certified public accountants have achieved statutory recognition, and they have created and very nearly perfected [a responsible professional] organization. . . . But . . . [they] may not yet have won general public recognition that they constitute a profession rather than a highly technical and specialized vocation."

Later he advises:

> "The profession needs to *reveal itself*—positively, with assurance, naturally, consistently. It needs to become known for what it is—the one 'discipline' in the business community in an age when society is primarily a business society . . . [with] the tasks of management more complex and therefore more dependent on skilled professional aides . . . The profession needs to consider whether it is reaching out to take advantage of all the opportunities of leadership and service that occur to professions as distinct from other groups."

It is not enough for members of a profession merely to think they are good and sufficient, or merely to tell the public so. The public must be brought to understand what a profession can do, and the profession must demonstrate its ability to do the thing it holds out to be able to do.

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[6] "The General Recognition of Accountancy as a Profession." American Institute of Accountants, 1956.

Enlarging Responsibilities and Opportunities in Accounting

We have reviewed the kaleidoscopic course of accountancy in the eventful decades of the twentieth century. We have indicated the upward progress made toward a true professional status and the vacuums that still exist in that advancement. In doing this we have pointed out some of the challenges still facing the profession. What then are the opportunities and rewards that are ahead for the future? Have such opportunities already been exploited or are new ones in store?

The Commission on Standards of Education and Experience for Certified Public Accountants concluded that "CPAs have only begun to furnish the services they are capable of providing and which they may be expected to perform in the future."

In professional circles there has been in recent years a vast amount of discussion as to what accounting can and should do for *management*, and how its efforts can be directed toward that end. The implication is that something new has suddenly been discovered. On the contrary, accounting has always been a vital feature of management. The trouble is, it so often has not been used that way. Why?

In the first place, management has depended too much on experience, rule of thumb, guesswork, or intuition in dealing with its problems, and too little on the facts produced by accounting.

But secondly, the methods of accounting were too slow, too involved, too remote from the questions faced by management to make it fully serviceable. Too much of the mere (though not unimportant) element of

verification persists in accounting practice.

If accounting is to serve management, it must correct these deficiencies, pull down the barriers, come closer to and give earlier answers to management questions. It must not stop with answers to the question, "What are the facts?" It must also be able to answer the more important question, "What do the facts mean?"

This means not merely the dull, colorless reporting of financial data which has characterized so much of the auditor's work in the past. It means the presentation of that material in concise, meaningful form, and the ability to apply judgment and insight to its content and implications. It means relating it to present operating needs and future planning.

We can give hearty thanks and tribute to the successful efforts of business machine manufacturers in developing mechanical aids to recording and analysis of transactions. By their ingenuity, resourcefulness, industry, and willingness to take risks, they have taken a large part of the drudgery out of record keeping, and otherwise simplified and expedited the recording and assembly of data necessary in accounting control and reporting. They have been greatly aided by university scientists, persistent inventors, and their own research and development staffs. Their efforts have paid them good dividends financially, but we as accountants as well as the entire business community and public are also benefactors.

But, as former Institute President, now Federal Budget Director Maurice Stans said in his address to the 1955 meeting of the Institute, "Machines can only provide the raw materials of accounting. Analysis and interpretation—use of the financial information—require the skill and judgment of the trained accountant."

There are many by-lines to the primary functions of accounting and auditing which every qualified accountant is basically prepared to meet. They are well set forth in the Institute bulletin, "A Classification of Management Services by CPA's."[7]

Those listed include counsel on:

1. General management and administration;
2. Financial management;
3. Production;
4. Marketing;
5. Office management;
6. Purchasing;
7. Traffic and transportation;
8. Personnel;
9. Research and development.

These do not reduce in importance and should not interfere with his indispensable service as an auditor and as supervisor of or advisor on accounting. They are natural supplements to these basic functions. They help to bring the accountant and auditor into management instead of being restrained in a side-line position as is frequently the case.

The extent to which any individual accountant can and should undertake to render such services depends upon his training, experience, and personal ability. He should only undertake those in which he has acquired knowledge and judgment necessary to do a competent job. But the opportunity is there, and the chance is his, if he

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[7] American Institute of Accountants, 1956.

Two additional recent articles are worth mentioning: (1) Robert M. Trueblood: "Accounting and New Management Attitudes," *Journal of Accountancy*, October, 1958. (2) "Management Services by CPA's," *Accounting Review*, October, 1958.

will but recognize and prepare for them, and let his clients know of his availability to do them.

What Does the Profession Need to Take Advantage of These Opportunities?

What does the profession need to do further to assist its members to measurably meet these new challenges? I have but to summarize things that I have discussed or alluded to already:

1. A more definite codification and general agreement on what constitutes "*principles of accounting.*" This should include a recognition that there may be distinct variations applicable to areas other than private business.

2. A broadening of the *standards of auditing,* to make them include more of the basic elements around which procedures can be securely developed.

3. Extension of the membership of national accounting bodies, particularly the American Institute of CPAs.

4. Increased recognition of the necessity for academic training and related research of the accountant and broadening of that training to make it the basis for a "learned" profession.

5. Increased emphasis on accounting as an inseparable *part of management,* and not merely a stand-by aid to management.

6. Encouragement of acceptance of opportunity on responsibility for *serving business and government* in ways beyond the narrow confines of accounting and auditing.

I should like to make some supplementary comments on two of these subjects. The first has to do with *principles.*

(a) Not infrequently the practices of non-profit institutions are questioned because they "vary considerably from those established for commercial enterprises and also vary between themselves." [8] This fact does not of itself make them invalid. The test is whether they are sound and adequate *for the particular type of enterprise* for which they have been developed. If they are, the fact that they differ from those appropriate for others does not make them incorrect, or call for their modification.

In at least two of the important areas of non-profit operations—municipalities and colleges—such principles have been competently and authoritatively developed and they have been widely enough applied to make them "generally accepted." Yet even after three decades they are still lacking in affirmation by professional bodies.

It was for this reason that some questioned [9] the claim in Statement 28 of the Institute Committee on Auditing Procedure that, in the examination of such enterprises, the auditor "has had little besides his own experience and judgment to guide him." Quite the contrary is true in the two areas mentioned.

Thomas L. Holton, speaking before the recent meeting of the AICPA, pointed out that when "an authoritative group" has studied a program, and has published recommendations which have "become generally recognized," where they have been followed it may be appropriately said by the auditor that the statements are in accordance with "generally accepted accounting principles."

[8] Robert L. Dickens, "The Formulation of Accounting Principles for Non-Profit Institutions," *New York C.P.A.*, June, 1958.

[9] See *Accounting Review*, July, 1958.

This, he concludes, is the situation in the fields of educational institutions and of municipalities, and this procedure should be followed in such reports where conformity to the standards thus established is found.

In the discussions of needed improvement in federal accounting in the Hoover Commission and elsewhere, severe criticism was made of the over-emphasis existing on control and accounting of obligations and cash and the lack of accrual and cost accounting. Congress approved legislation calling for correction of these matters, although they already had begun to have attention in many agencies.

In developing principles on which the required changes could be carried out, the General Accounting Office, while seeking material simplification of the system of budgetary control, nevertheless, in its recent Memorandum on Principles, found otherwise as indicated by this statement on the subject (underscoring added):

''Appropriation actions by the Congress, with limited exceptions, provide that obligations may not be incurred unless there is an appropriation or fund balance available therefor at the time the obligation is created.

''Every agency is required by law to have a system of administrative control which will restrict obligations or expenditures from exceeding the amounts appropriated therefor, the balances in the funds involved and the amounts of the apportionments or reapportionments made for the current fiscal period. The system of administrative control must be such as to fix responsibility for the creation of any obligation or the making of any expenditure in excess of an apportionment, reapportionment or other subdivision thereof determined administratively.

''For these reasons *the accounting system should provide for identifying obligations with the applicable appropriation or fund* at the time they are incurred unless there is an appropriflecting obligations should be supported by evidence provided by the accounting system in terms of expenditures and unliquidated obligations.''[10]

On the question of *accrual accounting* the memorandum states:

''The accrual basis of accounting should be used in each instance *to the extent that accounting results will be significantly improved* and thereby increase the value of accounting management and others . . . ''

The basic statement on *depreciation* is:

''Depreciation of fixed assets should be recorded *when* a regular determination of the cost of all resources consumed in performing or carrying out an activity *is needed.*''

These are singularly close to the principles advanced by the respective committees on accounting in universities and colleges and for municipalities: a *modified* basis of accrual accounting and a *selective* basis of depreciation accounting. These points are currently the subject of considerable criticism mostly by persons who have not taken the pains to inform themselves as to the problems involved or the thoroughness with which they have been attacked.

(b) Further comments have to do with the kindred subjects of *education* and *research.*

Clearly through the efforts of energetic and progressive educators and faculties and the encouragement of the profession, great progress has been made toward development of

suitable programs of higher education for prospective accountants. But in addition to the wide variation in quality among the many schools offering such training, there is a considerable lack of agreement on what constitutes the best program.

The nature and effectiveness of these programs have been well analyzed by the Commission on Education and Experience for Accountants.[11] The Commission emphasizes that, for the training of a CPA, the following are needed: (1) general cultural background; (2) business administration and economics; (3) communication; (4) standards of professional conduct; (5) principles of accounting; (6) principles and standards of auditing.

It is to be noted that the broad emphasis is on *education,* not merely training, and on *principles* and not merely methods. The Commission says:

> "A general cultural background is needed to prepare the CPA as an educated man capable of meeting members of other professions on an equal footing, economically and socially, and in civic and business affairs. (This) is harder to define than technical training, but it is probably more fundamental and important. (It) is best provided in colleges and universities."

One important factor is that of keeping abreast of changing conditions and changing methods. The first point of attention in this respect is in the college. The teacher of accounting who uses the same notebook year after year is doing his students a disservice. Textbooks can not be reprinted for every term, but the teacher can, if he will, supplement the texts by up-to-date references to new developments.

But education does not stop with leaving college; there should be continuing study by every accountant regardless of his stage of development. This can be done in part by reading of current technical literature, by attending conventions and conferences, and by taking advantage of review courses and clinics.

The American Institute has taken constructive notice of this need by its recent establishment of a program of *continuing education* financed in part by the Institute.[12] This is a most commendable project and one which should pay good dividends. Some may not altogether agree with the statement by former U. S. Commissioner of Education, E. J. McGrath, that "practicing accountants rather than teachers must assume the major responsibility for continuing education." This is not the case in other professions such as medicine and law where such work has attained great vogue. Much of such work is organized by and carried on at university campuses, though usually in cooperation with the profession, and usually on a fully or largely self-supporting basis. To the extent that the heavy loads on college factulties for resident undergraduate and graduate instruction make possible, this should be the case with such work in accountancy.

Programs of this kind should include technical problems and areas, but not be limited thereto. They should extend into the field of executive development, thus opening the way for the accountant who has talents of this kind to cultivate them in preparation for possible opportuni-

[10] Controller General of the United States: Accounting Principles Memorandum, September, 1957.

[11] See Robert L. Kane, "Education for CPA's," *Journal of Accountancy,* June, 1957. Another excellent analysis of this problem has been made by the Association of Collegiate Schools of Business. See *Beta Gamma Sigma Exchange,* Spring, 1956.

[12] See "The Urgency of Continuing Education," 1958.

ties where his skills and knowledge as an accountant can be combined with other abilities to form a foundation for higher responsibility in business and elsewhere.

No profession is complete in its program of activities unless there is continuous *research* on its problems. Accountancy is no exception. While some notable contributions which could meet the tests of research standards have been forthcoming, the extent of such output has been relatively small. There is a great gap to be filled in this regard, calling for independent scholarly study in accordance with scientific standards of inquiry. Professional bodies can do something in this respect, just as do other professions and as do industry and government. The recent effort of the American Institute to extend and develop its own research departments is commendable and should be fruitful.[13] Yet the great seat of pure research is still in the universities, and that may well be true in the case of accounting. Real research can only be done by scholarly persons of adequate academic background. They function best in an "academic" environment. The profession and business itself can offer much in financial help for such effort through grants, fellowships, and cooperation. But the "ivory tower" protected by its bulwark of "academic freedom" may still hold the key place in this needed advancement.

For the adequate carrying out of the educational program needed for the profession, a sufficient body of competent teachers is essential. Industry, government, and the profession can not expect the supply of accountants to be maintained and their quality to be improved unless there is capable teaching. Fine buildings and libraries are insufficient to accomplish this end. There must be people in sufficient numbers and of proper quality. The opportunities and rewards of teaching in comparison with other accounting employment need to be emphasized and improved.

Conclusion

These are to my mind the great *new vistas* in accounting. These are some of the things the profession needs to do to aid its members to move forward into them. These are the horizons beckoning both the present day accountant and the student preparing to become an accountant. For the latter in particular, the opportunities are exceptionally diverse and offer him a choice as to the directions he may go.

The first of these directions is public accounting. In this there is the greatest challenge, the widest opportunity, and at its best the largest financial reward. It also carries the greatest risk.

The second is industrial or business accounting, where good personnel is essential to accounting advancement and achievement. Here too, opportunity is strong and possible rewards are high. Sometimes these unfortunately are not decided solely on merit.

The third is in governmental or institutional work where good opportunities exist, though more limited financially. Currently the best chances seem to be in the federal government, and these are well worth considering.

Fourth, and of high importance, are the opportunities in teaching and research. For those who are at all scholastically minded, I urge careful consideration of this area. Money returns are more limited but are not in-

[13] See *Journal of Accountancy*, December, 1958, p. 62.

adequate. Other compensations exist which at least to a degree offset such limitations.

We can be proud to be members or prospective members of such an important vocation. We can be pleased with its accomplishments, but we can not be satisfied with them. There are still greater possibilities and demands ahead. As long as we continue in the lofty spirit of integrity and independence which are fundamental to our profession, we can look forward to higher and higher levels of accomplishment, public service, and personal satisfaction, as well as reward.

"THREE MONTHS AT HARD LABOR"

The story of an unusual engagement for the examination of the financial statements of the Illinois State Penitentiary, Joliet Branch

By Richard J. Matteson

During the spring of 1958, our office received instructions for an examination which led to the "sentencing" of a group of the audit staff to a three-month stretch in Stateville, a maximum security prison in the Illinois State Penitentiary system. Instructions for the examination of the financial records of the institution for the two years ended June 30, 1958 were received from the Honorable Frank H. Whitney, Auditor General, as a part of his comprehensive statewide program of post audits of state agencies by the accounting profession. The newly created Department of Audits under the direction of the Auditor General is part of the corrective legislation which grew out of the revelation in 1956 of the extensive defalcations in the office of the Auditor of Public Accounts.

The Beginning of Our Sentence

When we turned into the drive to the main gate of Stateville for our first day of incarceration, the rich lawns, multicolored flower beds, trees and shrubs looked more like an arboretum than what we expected of the entrance to prison. At the gate we enacted a scene which was to be repeated each time we entered the institution. After emptying all pockets onto a counter top, we were thoroughly frisked by a guard and relieved of all items considered contraband. These articles were returned upon leaving the institution and included such seemingly innocent items as nail files, postage stamps, gum, cough drops and mechanical pencils. The need for these precautions was demonstrated to us later in the examination when we were shown a mechanical pencil confiscated from a visitor. The top half of that pencil enclosed a tear gas cartridge. After the shakedown we passed through a small hallway equipped with an electric device which would detect any metal object overlooked in the search. The door at the end of the hallway is opened by remote controls operated by the gatehouse keeper. We were then directed to the administration building to meet Warden Joseph E. Ragen, who since coming to the institution as warden in 1935 has earned the reputation as one of the outstanding penologists of our time.

Warden Ragen is the chief administrator of the four prison plants in and near Joliet, Illinois, comprising the

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Portion of the prison yard at Stateville showing one of the formal gardens and inmates in the background during recreation period. The chapel building at right seats 1700 persons and also serves as the movie theater and recreation hall.

Stateville and Joliet prisons, the honor farm, and the diagnostic depot, which together house some 4,600 inmates. Stateville is the largest of the plants and upon entering it for the first time one is affected with wonder and astonishment at its immensity, the beauty of its formal gardens and magnificent landscaping, and the forbidding aspect of the wall. The yard is 1,840 feet long, more than a third of a mile, and 1,500 feet wide. The wall, 32 feet high, seven feet thick at the base pyramiding to fourteen inches at the top, encloses 64 acres, the largest prison yard in America. The wall is made of reinforced concrete extending nine feet below the surface. At intervals of 600 feet there are guard towers on top. A circular dining hall building is located in the center of the enclosure and like the spokes of a wheel, walkways lead off to one large rectangular and four circular cellhouse buildings.

The prison proper is entered from the rear of the administration building through three separate turnkey attended gates. Between the first two of these gates is the guard hall, where officers of the day assemble for instructions before going on duty. Projecting from one side of the hall is a semicircular room with bulletproof windows, gun ports, and small turrets in which machine guns can be rotated to spray both gates with bullets. This is the prison armory, and the officer on duty there has the most stategic position in the prison. It is his duty to keep watch on the guard hall and on both gates. The two gates are never opened at the same time. Neither are the two barred doors and one armored door leading into the armory. Under standing orders, if visitors accompanied by Warden Ragen himself should approach those doors, they could be shot. The reason for this is that the visitors could be armed and using the warden as a decoy to gain admission to the armory. Every effort would be made to overpower the visitors before shooting, but if the attempted entry were strong enough, it would be necessary to stop them. The visitors wait in the guard hall while the warden alone is admitted to the armory. Then he gives the order and the visitors are admitted. In a room behind the armored room is an arsenal of pistols, rifles, machine guns, and tear gas guns. All are loaded, ready for use. On one wall there are keys for every door and gate in the institution. When a guard takes out a weapon or a key he leaves his "dog tag" bearing his serial number as a receipt. Also in the armory is an entrance to a series of tunnels connecting the cellhouses, dining hall and other buildings inside the wall. Other than the armory and the towers atop the wall, weapons are carried in only one location inside the prison, the steel guard tower in the center of the circular dining hall. The dining room where approximately 2,000 prisoners at a time are assembled for meals is potentially the most dangerous location within the prison. Knowing that the guards inside the walls are unarmed, we were surprised one day to observe a guard carrying a steel rod approximately two feet long. Inquiry revealed that this man was engaged in "ringing the bars." All bars in the cellhouses are struck each day with an iron rod to detect any that may have been tampered with or partially sawed. If a bar is unsound it will not ring with the proper tone.

The Circular Cellhouses

Stateville's circular cellhouses are unique. The interiors are something like a European opera house as viewed

from the stage, except for the steel guard tower in the center. There are 248 cells on four tiers in each house. There is a narrow gallery for each tier of cells. This is the so-called panopticon (seeing all) cellhouse. The guards in the center tower can look into each cell. However, Warden Ragen has pointed out that whoever designed it forgot that the guard can't see the prisoners who are behind his back, whereas, the guard is like a goldfish that all prisoners can watch. A large rectangular-shaped cellhouse building was constructed after the circular cellhouses, and has proven more practical. These cells are built back-to-back with a utility tunnel in the center. Although designed for single occupancy, most cells have two men and some have three because of the large inmate population. However, homosexuals and a few other deviates are confined in individual cells. A cell is 6 feet wide, 9 feet long and 8 feet high. There is not much room to pass by the bunks to the toilet and lavatory in the rear. Each one has a medicine cabinet on the wall and a chest of drawers which has drop leaves and serves as a writing table. The beds are made up by the inmates army-style, the blankets turned back to expose clean white sheets, and stretched so tight that you could bounce a dime a foot high. Each bunk is equipped with radio earphones which permit the inmates to select one of three stations tuned in by a master control. Although these accommodations are meager and confining, they appear deluxe when compared with the cells still in use early in this century. One of the original cells from the old Joliet prison which was completed in 1858 has been retained as a museum piece. The old cell was 4 feet wide, 7 feet long, 7½ feet high and had no plumbing.

Life Behind Bars

Our introduction to life "behind bars" was certainly an interest-absorbing experience, although it was quite different from those invited to attend by the courts of Illinois. The convicted felon is received at the diagnostic depot where the State Criminologist's team of sociologists, psychologists and psychiatrists "bug" the man to determine whether to send him to the hospital for the criminally insane or to assign him to one of the several prisons in the State. They also recommend what type of work he should be given as an aid towards his rehabilitation. The stay of several weeks in this depot is also used by the prison officials to orient the inmate as to his rights and duties and to outfit him in his state garb. On admission he is relieved of civilian clothing and any personal effects he may have which are not authorized. Items of value, except clothing, will be mailed to the prisoner's home upon request or held in safekeeping and returned to him upon discharge.

Inmates are not permitted to handle any money and all of their financial transactions are recorded in trust accounts maintained in the business office. Amounts are credited to an inmate's account for the money he may have had upon entering, deposits by relatives or friends which must be mailed in by check or money order and endorsed by the inmate, wages received from prison industries, and sales to blood banks, etc. Charges against an inmate's account arise chiefly from purchases at the prison commissary, which is equivalent to a small town general store. If his conduct has been satisfactory, an inmate may visit the commissary weekly and

spend up to $5 for such items as tobacco, candy, pastry, toilet articles, and food items. The commissary profits go back to the inmates in the form of athletic equipment, movies, band instruments, library books, school supplies, and the like. They may also purchase, through the business office, such authorized articles as books, magazines, typewriters, savings bonds.

Confirming Trust Account Balances

Confirming the trust account balances was one of the more interesting parts of our examination. Since written confirmations were not practicable and receipted records are not furnished to the inmates, confirmations were obtained orally when selected inmates visited the commissaries. Identification of inmates was no problem as their numbers are stenciled across the back of their jackets and on various other clothing. A more positive and scientific means was also available as each purchaser, in addition to signing his order, must affix his fingerprints thereto. On a limited test basis we selected a few of these prints for classification by the institution's bureau of identification. The inmates contacted were generally very cooperative and informed as to the exact amount of their balance. Those who professed ignorance of the amount usually had little or no funds to their credit. It was obvious that these men operated on the theory that any error in the accounts must be in their favor. After confirming, one of the inmates returned after a few moments of cogitation and inquired as to what could be determined about him from the fact that he knew his balance. Upon being informed of the purpose of our request, he remarked, "Oh! I thought you were one of those head doctors." This incident illustrated the continuing interest and study of the inmates by the professional staff of the crimologist throughout the period of confinement. Their examinations are required immediately preceding parole hearings and their recommendations have considerable influence on the deliberations of the parole board.

Although most of the confirmations were obtained at the commissaries, random selection techniques produced the accounts of a few inmates who were being denied commissary privileges at the time. To obtain these confirmations the auditor interviewed men in the "crank gang" who were finding it difficult to adjust to their environment, inmates assigned to the coal pile, and one confined in the segregation cellhouse. The segregation unit (a prison within a prison) is reserved for chronic trouble makers and men who will not abide by the rules. There is no limit on their segregation; they may stay there for life unless they promise to abide by the rules and convince the warden that they mean it. Segregation cells have cots and the same plumbing facilities as those in the main cellhouses. Prisoners confined there eat the same wholesome food as other inmates, three meals a day, but they eat in their cells. There is only one man in a cell and he cannot see the prisoners in adjacent cells. They have to shout to converse. From three to five times a week, depending on the weather, inmates in segregation are permitted to exercise for 30 minutes, one man at a time, in a small yard enclosed by a 20-foot wall. There are seldom more than 20 men in segregation at any time and the record for stubbornness is held by a man who served eleven consecutive years of his sentence in a segregation cell.

"The Hole"

The isolation units, often referred to as "the hole," are attached to the segregation section. Prisoners who are not chronic trouble makers, but have committed serious offenses against prison rules, are punished by confinement in isolation cells for a maximum of 15 days. They get only one meal a day, the regular noon meal served to all inmates, and it is brought to them. Up to four men are confined in a cell and they have no bunks. They sleep on blankets on the concrete floor. The doors to these cells are solid, but each has a large window at the back and it is well lighted. Such punishment is not to be confused with "solitary confinement," in dark, dungeon-like cells on a diet of bread and water, which is standard practice in some prisons, but not at Stateville.

Comprehension of prison life to one who has never been behind bars is likely to be limited to Hollywood's portrayal of burly guards with clubs pacing back and forth waiting for an inmate to fracture a rule so the guard can get his daily exercise. Although not as dramatic, the Illinois State Penitentiary's methods are more humane and effective. The primary function of the prison is to keep the inmate secure until he is legally released. To do that safely and efficiently, one of the first and most necessary features is discipline. At Stateville, firm standards of discipline are maintained with the use of a tool more effective than a club—the pencil. When an inmate violates a prison rule, a guard writes a ticket describing the incident which is forwarded to the captain's office. A hearing with the inmate is held and the captain decides what punishment, if any, will be imposed upon the violator. Punishment ranges from temporary loss of privileges, such as movies, baseball games, and cell radio earphones to a 15-day stretch in "the hole." The prisoner may also have his previously accumulated "good time" or a portion of it taken away. This is a powerful deterrent to bad conduct. Prisoners serving so-called "flat time" sentences, imposed in Illinois for murder, kidnapping and rape, get one month off for good behavior ("good time") in the first year. This credit increases for longer terms to a maximum of one-third of the sentence. For prisoners serving indeterminate sentences there is a progressive merit system. with grades A, B, C, D and E. On admission, they start in the neutral C grade, in which good time is neither earned or lost. After three months, if their behavior is satisfactory, they advance to B grade, in which they earn five days of good time a month. Three months later they can pass to A grade, in which they earn ten days good time per month. A prisoner must be in grade A at least three months and must have served his minimum sentence, less credit for good time, before he is eligible for a parole board hearing. For misconduct, prisoners are demoted to lower grades. In grade D, they lose five days a month, and in grade E they lose ten.

Rehabilitation Efforts

Second only to security, rehabilitation is the next most important function of the institution. Rehabilitation of those assigned to a maximum security prison is a difficult and discouraging job as there are always many who again fail after their release, because they attempt to learn how better to violate the law. However, every effort is made to teach each man a useful trade during his incarceration. Those who do not have a formal education must attend the

prison school until they have completed at least the eighth grade, after which they are encouraged to attend high school and many do. After their high school studies are completed they are given an examination by members of the faculty of a nearby accredited school district, and if they meet the requirements, receive certificates which do not reveal that their education was acquired in the penitentiary. If the prisoner desires to further his education he may enroll in college courses by correspondence. The institution's vocational school program provides the means of mastering more than 40 different trades by on-the-job training. These include sign painting, electric welding, printing, woodworking, auto mechanics, radio, television, refrigeration, etc. The vocational school printing students turn out the Stateville "TIME" magazine, a publication for employees and inmates. The Warden and Chaplains also use the magazine as a means of reaching the men with informative and inspirational messages.

Inmates who have completed their schooling are assigned to various jobs mostly concerned with the operation of the institution and some of the "make work" variety to keep hands and minds busy. The job assignments are always on the basis of merit and opportunities for providing the men with the skills and know-how to earn an honest living upon release. The more desirable assignments for many of the inmates are the prison industries and the business offices where a man can earn up to $20 per month.

The prison industries are self-supporting and in addition provide a valuable service to the tax supported political subdivisions and agencies of the State. They are prohibited by law from selling their products to others. The industries include furniture, shoe, soap, garment and textile manufacturing, a sheet-metal shop and a book bindery. It was a most interesting experience to see some fifty men working in the book rehabilitation center, which restores and rebinds about 300 books a day. Most of these are textbooks used in the public schools. From a batch of 150 battered textbooks the prison returns about 140 in new condition. The others are "cannibalized" to supply missing pages. The 2,200 acre honor farm adjoins the Stateville prison. Some 400 trusties work on the farm. Of these, 180 live in the farm dormitory and the others are returned to the prison proper each night. All honor farm men are carefully selected. There are no sex offenders, no prisoners with escape records, no notorious characters. However, many are serving life terms. The farm produces a substantial portion of the meat, dairy products and vegetables consumed in the institution.

Spiritual Needs of the Inmates

Nor are the spiritual needs of the inmates neglected. The official attitude and religious services available can best be described with the following excerpts from Warden Ragen's message to all inmates:

> "A function worthy of your consideration is religious worship. We do not force any one to go to church, but we strongly urge that you attend one of the services which we offer. It would be utterly impossible to have a representative of every religious denomination in an institution of this type. We offer eight different religious services: Protestant, Catholic, Episcopal, Christian Science, Lutheran, Baptist, Jewish and Orthodox. It may possibly be that you never felt you had the time to devote to the practice of religion. Certainly this is not true now. Consider the great energy which men have put into religion. Think of the thousands of men who have willingly sacrified their lives for it. Certainly a subject which can move

so many so strongly would merit your investigation.''

During the course of the examination we came in daily contact with the inmates working as clerks in the business offices and various industries. On one occasion a staff member was shocked upon meeting an automobile salesman who had demonstrated a new car for him several months previously and had subsequently been returned to prison for parole violation. To say the least, it was a strange experience working alongside men that you know have been dishonest. At times an auditor may suspect that to be the case, but seldom does one know it with so much certainty. However, it doesn't take long to lose that uneasy feeling and you realize that they too are merely humans with problems. They soon appear pretty much like anyone else, except they do abound with the strangest tales and experiences which they are willing and anxious to relate. A two-time loser told of operating, among other activities, a junk yard during the eight years of freedom he managed to sandwich in between raps. In need of a carload of scrap to fill an order one week end and having three empty gondola cars on the railroad siding, he ordered his men to cut up two of the cars and load them into the third car which was then shipped to the customer. He believed that the railroads could not account for all of their cars and returned their demurrage bills with the notation that no such cars were held by him. Eventually an investigator from the railroad appeared and after touring the yard and being shown that the cars in question were not present, the matter was dropped. If that railroad is still tracing two unaccounted for gondolas, they should be advised that there is no hope of success.

How One Convicted Embezzler Did It

On another occasion a convicted embezzler proudly revealed his modus operandi. The system proved to be very simple, but also successful for he was able to work it for $7,000 to $20,000 per employer in numerous cities from coast to coast. He came a cropper upon being arrested in a midwestern state on a minor charge. After being identified as an embezzler wanted in several states, he was extradited to Illinois, the state having the most serious charge against him. The scheme started with the establishment of several postal addresses and applying for work as a bookkeeper for medium or smaller businesses. References were fictitious and letters mailed to them were received and duly answered from the addresses previously established. Once hired it was usually not difficult to maneuver himself into the job of reconciling the bank accounts. Blank checks numbered well in advance of those currently being issued were obtained from stock and made payable to a fictitious payee for which he had opened a bank account. If the company used a protectograph, the machine was generally readily accessible for use on his checks. Signatures were forged from the legitimate canceled checks in his possession and the fraudulent checks were then deposited to the bank account from which he could withdraw the funds at his convenience. The defalcations were temporarily concealed by destroying the fraudulent checks as they were returned to him from the bank and the reconciliations were made to appear to balance by underfooting or excluding checks from the outstanding list. The success of the practice depended upon leaving town before the annual audit, if one was made, or before the cash in bank

reached a dangerously low level. Perhaps this experience will be useful in convincing a skeptical client of the need for safeguarding blank checks and careful review of bank reconciliations.

Control In a Maximum Security Prison

We have been frequently queried by our colleagues as to the effectiveness of internal control in a maximum security prison. Needless to say controls over the inmate population are tight. There has not been an escape from within the walls of Stateville since seven notorious gangsters from the prohibition era engineered a break over the wall in 1942. Their method of gaining temporary freedom can not be used again, for the details of all escapes or attempts are studied carefully by the authorities and measures are taken to prevent their reuse successfully. Regardless of precautions, many of the inmates expend a great deal of time and effort in hope of executing a successful escape. Very recently six long-term convicts were confined to "the hole" when plastic keys and pieces of metal which could have been sharpened into knives were found in their cells. The keys apparently were intended to fit one of the two locks on the cells and had been made with tools kept in the cellhouse after toothbrush handles were softened by heating them with matches. Investigation of this escape attempt is continuing to determine if a guard was negligent in his supervision of the cellhouse tools.

Controls over inventories and other assets are also more rigid and complete than those normally considered necessary in civilian enterprises. This is necessary as a missing tool or ladder in the hands of an inmate may be used as a weapon or the device otherwise required in an escape plan. The emphasis on controls is novel as some of the most stringent safeguards are exercised over such items as coffee. Clandestine coffee brewing in the cells at night is one of the little things in prison life which assumes an abnormal importance. The warden pointed out another unusual control when he stated that there are no secrets in a prison. The inmates, while they generally will not report a fellow inmate who makes a score, are delighted to point out the guard who is not properly safeguarding the assets. This facet of control prompted the staff to describe the inmates' function as "inmate-ternal control."

The Engagement Ends

The entire staff assigned to the prison examination enjoyed their unique experience behind bars. However, we left the institution upon completion of the work with some feeling of relief. In associating with the inmates for a period of time one cannot help but develop a compassion for their situation, even though their incarceration need not be entirely unpleasant or useless. There was also the hazard to the reputation of the staff men carrying out the field work for this examination. On one occasion the president of an out-of-town client placed a telephone call to the office for the manager. Our operator obtained the necessary information to return the call and then called Stateville to relay the information to the manager. For some unknown reason the client's operator overheard her call the prison. Upon returning the call, the manager was greeted by the client's president with "I hear you're in the penitentiary Is there anything I can do to help you out?"

Our families and friends will long remember the beauty of the grounds

within the walls of Stateville which were shown to us on Saturday afternoon on a tour arranged by Warden Ragen. The beautiful flower gardens and lawns trimmed to perfection certainly must be a great pleasure to the inmates. They, of course, are not permitted to tiptoe through the tulips unless they are applying a manicuring tool. Once each year when the sweet corn is at its best, the warden arranges a picnic on the prison farm for employees, law enforcement and other officials from surrounding communities, and other guests. The inmates take this opportunity to combine their prayers for rain to fall about half way through the meal. The potency of this mass effort must be substantial for the record of answers is indeed high. One of our more vivid memories of the engagement is the fried chicken and sweet corn picnic meal which we finished with our colleagues — underneath the picnic tables!

STOCK REDEMPTIONS

By Jack Macy

When a business has accumulated funds which are not required for current operations or posible future expansion, it is logical that these excess funds should be returned to the stockholders. This return of funds gives rise to the problem of whether the stockholders should be taxed at ordinary rates, as on a dividend, or under the generally more favorable capital gains provisions, as on a sale or exchange of stock.

If the funds are distributed without any redemption of stock, the dividend treatment is ordinarily inevitable. The problems arise when the distribution is made in redemption of stock. The general rule in such cases is that the distribution will be treated as consideration in exchange for the stock redeemed.

If there were no exceptions to this general rule, there would probably be few taxable dividends. As an extreme example, slightly over six months before each dividend date a corporation might distribute a tax-free stock dividend. On the dividend date this stock would be redeemed. All interests would be as they were before the cycle began except that funds would have been transferred to the stockholders without payment of any dividend tax.

To prevent this result, there has long been the familiar provision taxing as a dividend any distribution in redemption that was "equivalent" to a dividend. When the 1954 code was enacted, there was an effort to bring a degree of certainty to this field and exchange treatment was prescribed for distributions that meet certain specific tests. Sometimes forgotten, however, is the fact that the code still gives taxpayers the opportunity to qualify under a general provision applicable where a redemption is "not essentially equivalent to a dividend."

There are certain situations that might not meet the specific tests where there are some favorable court decisions under the more general rule. Among these situations is a general contraction of business requiring less working capital (as distinguished from complete termination of a business which is now specifically provided for). Another is termination of an individual's interest without regard to attribution of stock held by related parties.

It is by no means clear that these rules will continue to be followed to the extent that they might be considered to be out of harmony with the specific provisions. It is obviously safer to qualify a transaction specifically where possible. But it is well to keep in mind that all is not necessarily lost if a transaction that has occurred does not quit fit. If it seems to meet the general test of not being equivalent to a dividend, there is every reason for contending for treatment as an exchange.

JACK MACY is a partner in the firm of Haskins and Sells, Chicago. This article is adapted from a paper which was presented at the 1958 Joint Tax Conference sponsored by the Illinois Society of Certified Public Accountants and the Illinois State Chamber of Commerce and held in Chicago on December 15–16.

Disproportionate Redemption

One of the specific provisions whereby a stock redemption can qualify for exchange treatment is the substantially disproportionate redemption. Generally, no redemption will be considered as substantially disproportionate unless after the redemption the stockholder in question owns less than 50% of the voting power. He must also own, after the redemption, less than 80% of the proportion of the voting stock that he held before the redemption. For example, if he started out owning 400 out of 1,000 shares or 40%, he would have to wind up owning less than 80% of 40% or 32%. If 200 of his shares were redeemed, he would have 200 out of 800 remaining or 25%. He would thus meet the 80% requirement.

However, in determining whether these percentage-of-ownership tests are met, consideration must be given to so-called "constructive ownership." There are several points of danger in these rules and also some opportunities for tax planning.

Generally, an individual will be considered to own stock owned by certain other members of his family: that is, his spouse, parents, children, or grandchildren. It should be noted that this rule will not be applied in steps to broaden the circle. Thus, a husband is considered to own constructively stock actually owned by his wife. Also, the husband's father will own constructively his son's stock. But the stock of the daughter-in-law will not be attributed indirectly to the father through the son.

It should also be noted that there is no constructive ownership as between brothers and sisters. Although a grandfather constructively owns his grandchild's stock, the grandchild does not constructively own his grandfather's stock. Under appropriate circumstances, this rule may be very advantageous in planning.

For purposes of the disproportionate redemption rules, there appears to be no prohibition against preliminary adjustment of family interests either through gifts or purchases.

In the case of partnerships, trusts, and estates, the partners or beneficiaries are considered to own proportionately the stock owned by the partnership, trust, or estate, and each of those is considered to own all of the stock owned by any partner or beneficiary. Similar rules apply between a corporation and an individual who owns 50% or more of the stock.

These rules are applied cumulatively. For example, if an individual owns all of the stock of A corporation which owns 20% of the stock of B corporation, the individual's wife would be considered as owning the stock of B corporation held by A corporation. That is, the B stock would be attributed to the individual because of his ownership of A and it would then be attributed to his wife because of their relationship.

The possibility of some unexpected attribution, if, for example, an individual's partner held stock of which he was unaware, should be carefully considered. In this connection it is quite possible that some relationship such as a joint real estate venture not ordinarily considered a partnership might be so considered for this purpose. As much of the stock as possible should be accounted for and the relationships carefully examined in any disproportionate redemption situation.

Complete Termination

Another way of achieving an exchange rather than a dividend is through a complete termination of a

shareholder's interest. Where there is a complete termination, the family attribution rules previously described do not apply. The rules relating to constructive ownership with respect to partnerships, trusts, estates, and corporations continue to apply, however. Except where other family members are substantial shareholders, a termination will ordinarily also qualify as a disproportionate redemption. Because of other complications, the disproportionate redemption is usually simpler and safer where it can be achieved.

In order to achieve a complete termination where ownership by other family members makes this necessary, the individual must have all of his stock redeemed and must not remain as an officer, director, or employee. He can, however, be a creditor. This permits redemption that might not otherwise be possible where the corporation has insufficient funds to buy all the stock. In such cases it may issue debt obligations to the retiring stockholder.

Once having applied the termination provisions, the individual must not acquire any interest in the corporation for 10 years from the date of distribution except by bequest or inheritance if he is to continue to avoid dividend tax.

In addition to the rules relating to transactions that can adversely affect a termination if they occur within 10 years thereafter, there are also rules relating to transactions that have occurred within 10 years prior to the termination.

One of the prior transactions that can have an adverse effect is an acquisition of stock from a person whose stock would be attributed to the individual under the family rules previously discussed. This rule is designed to prevent a husband, for example, from giving part of his stock to his wife and then having that stock redeemed within ten years.

The other prior transaction to be considered would relate to a transfer to a person whose stock would be attributed to the individual under the family rules. If the transfer took place within ten years prior to the distribution and that individual owns the stock at the time of distribution, there will not be a termination such as to avoid the family attribution rules unless the transferred stock is redeemed in the same transaction. This rule might prevent, for example, a husband giving part of his stock to his wife and then having the stock retained by him redeemed within ten years. However, there would appear to be no restriction here if the wife's stock were transferred to someone whose ownership would not be attributed to the husband—for example, his brother.

In either of these situations, receipt of stock from a family member or transfer to a family member, the adverse effect can be avoided if it can be shown that the transfer did not have Federal income tax avoidance as a principal purpose.

Redemption to Pay Death Taxes

Relief from the general rules concerning possible dividend treatment of stock redemptions has been granted in one important area. Where an owner of a closely held corporation dies and his estate is faced with the need to raise estate tax money, the only asset of sufficient value is often the stock. If the stock were marketable, the necessary funds might be raised through sale. But a closely held stock usually has no great market and the only possible course may

be to have the stock redeemed by the corporation.

In appropriate circumstances, this redemption is treated as an exchange. Usually this means little or no income tax because the basis is fair market value at date of death (or one year later).

In order to qualify, the stock to be redeemed must constitute at estate tax value either more than 35% of the gross estate or more than 50% of the taxable estate. If the decedent owned more than 75% of the stock of each of two or more corporations, these stocks may be grouped for purposes of meeting the 35% and 50% requirements.

There is a limit to the amount of stock that may be redeemed under the protection of this provision. It is limited to an amount equal to the estate, inheritance, and other death taxes and to the funeral and administration expenses.

Advance planning will often permit this provision to be utilized where it might be lost in the absence of care. For example, if the stock in question almost but not quite meets the 50% test, a comparatively small charitable bequest might solve the problem. Or additional stock could be acquired. Where two corporations are involved but ownership in either is 75% or less so that they cannot be grouped under the rules just described, there might be advantage in creating a holding company to hold both stocks. The holding company stock might then meet the 35% or 50% requirements.

A redemption for these purposes will ordinarily occur within a year or so after death. A value will have been established for estate tax return purposes and a redemption value—usually about the same—will have been negotiated with the corporation. However, the estate tax return will usually be examined later, and there may be some upward revision in the ultimate valuation. For example, assume that 1,000 shares are redeemed at their estate tax return value of $100 per share or $100,000. The final estate tax value is $125,000. With hindsight, it appears that an additional $25,000 could have been removed tax-free from the corporation assuming that taxes and administration expenses exceed $125,000. Consideration should be given to having an original redemption negotiated on such a basis that either the total dollar amount or the number of shares can be adjusted if valuations are adjusted.

What have been discussed to this point are direct stock redemptions, that is, transfers of stock to the corporation itself. I should like now to turn to some of the indirect ways that might be used to accomplish somewhat the same result and discuss the tax treatment that might be expected.

Indirect Redemption Problems

It is rather fundamental that an individual who buys stock can generally sell it later to another and have any gain treated as gain from exchange whether or not the gain is due to the accumulation of earnings. Can, then, an individual who owns two corporations cause each to buy from him stock of the other and receive the same treatment?

The answer is "no" by virtue of a special provision in the code dealing with such situations. Dividend treatment is generally accorded in two situations: (1) where a 50%-owned subsidiary buys stock of its parent from a shareholder, and (2) where a corporation which is not a subsidiary buys stock in another corporation

from one or more of the persons in control (with 50% ownership) of each.

Although the dividend result is ordinarily the same in either case, the method of arriving at the result is different. This difference can be important because a distribution is a dividend taxable at ordinary rates only to the extent of the earnings and profits of the corporation making the distribution.

In the case of a purchase by a subsidiary of its parent's stock, the transfer is treated as a redemption of the parent's stock. The property given by the subsidiary is treated as though it were first distributed to the parent and thence to the stockholder. The effect is to use the earnings and profits of both companies in determining whether the distribution is a taxable dividend.

Where there is a brother-sister relationship between corporations instead of a parent-subsidiary relationship, the distribution is regarded as made by the acquiring corporation and the dividend nature is determined solely with regard to its earnings and profits.

Another indirect approach to achieving a benefit from corporate stock is the so-called "preferred stock bail-out."

This problem was dealt with in the 1954 code but only with respect to stock issued on or after June 22, 1954. The old rules still apply with respect to stock issued before that time.

In general, it seems reasonably clear that pre-1954 code preferred stock can be sold with any gain treated as gain from sale or exchange. If the stock was received tax-free as a dividend or in reorganization, that fact will be considered in determining the amount of gain but will not destroy the nature of the transaction. If the stock is sold subject to immediate redemption by the corporation and, in particular, if it is redeemed shortly after sale, controversy with the Treasury is possible, but authority seems to be on the taxpayer's side.

A very different set of rules exists with respect to certain stock issued on or after June 22, 1954. These rules do not generally apply to common stock. They do apply to other stock received as a tax-free dividend or in a tax-free reorganization or spin-off. The theory is to tax the recipient at the time he disposes of the stock as though he had received a dividend.

There is some difference in treatment depending upon whether the disposition takes the form of a redemption or some other form. A disposition might include a pledge where the pledgee could only look to the stock itself as his security.

In the case of a sale, the amount realized is treated as ordinary income to the extent of the stock's ratable share of earnings and profits at the time of distribution. It should be emphasized that earnings and profits at the time the stock was distributed control for this purpose. The fact that they may have been distributed as a dividend between the time of the stock dividend and the subsequent sale of the stock is immaterial. Any excess of proceeds over the amount treated as ordinary income applies to the basis of the stock sold and, after the basis is exhausted, is ordinarily subject to treatment as gain from exchange. No loss is allowable.

In the case of a redemption, the amount realized is generally treated as a dividend to the extent of the earnings and profits at the time of redemption. Any excess would apply

first to basis and then would normally give rise to capital gain.

A comparison of these rules suggests that in some cases a sale would give rise to less ordinary income and in some cases redemption would be more favorable. If dividends or losses since the stock distribution have exceeded earnings, a redemption may be more favorable. But note that if less than the entire amount of tainted stock is being disposed of, the sale route apparently produces ordinary income only to the extent of the earnings that were allocable to those shares whereas redemption may be considered as a dividend to the extent of the entire earnings and profits at the time of redemption.

There are certain exceptions to the rules which provide this ordinary income result for stock "tainted" by section 306.

One such exception relates to a sale of the shareholder's entire interest to someone whose interest is not attributed to him. All stock attributable to him must be disposed of.

Another exception relates to a redemption that constitutes a complete termination under the rules previously discussed including those limiting the attribution of family-owned stock.

A further exception relates to redemptions which represent partial or complete liquidations.

Still another exception is for transactions wherein gain or loss is not recognized. This includes exchanges pursuant to reorganization and also exchanges whereby common is exchanged for common or preferred for preferred in the same corporation. Unless the stock received in these tax-free exchanges is common stock, it will be subject to the same restrictions as the stock given up.

There is a final general exception for transactions that can be shown not to have tax avoidance as a principal purpose. This exception is primarily intended to appy to isolated dispositions by minority shareholders. It may also apply where the stock with respect to which the tainted stock was issued was previously redeemed or is redeemed at the same time as the tainted stock.

If stock subject to these restrictions has been issued, what are some of the steps that can be taken? One possible step that would not solve the basic problem is a gift of the stock to another member of the family. The stock would have a transferred basis and would still be subject to the same drawbacks in the hands of the donee. Another step that would be equally unavailing to remove the taint would be a tax-free transfer for stock of a controlled corporation. The stock received in exchange would be tainted —even though it is common stock.

However, there is nothing to prevent use of the tainted stock for deductible contributions to a qualified charity. If the charity subsequently sold the stock, it being tax-exempt, there would be no problem as to the nature of any gain.

If the stock received is held for the remainder of the recipient's life it loses its tainted character when it takes a new basis by passing through the estate.

Stock received as a dividend or pursuant to a reorganization is subject to these rules only if it is not common stock. The question may then be raised as to what can be done with common stock, and what, if any, differences can be applied to different classes of stock and still have them all classified as common.

It would seem reasonably clear that

an ordinary common stock dividend could be received by a nondealer and sold to outsiders on a capital gains basis. The effect of this would simply be a division of the original holding entirely comparable to a sale of part of the original holding. If, however, the stock sold were shortly thereafter redeemed, the economic effect would be a bail-out hardly different from the result of a pre-1954 code preferred stock bail-out. If the redemption was planned at the time of the sale, Treasury attack could surely be anticipated. The Treasury has ruled that redeemable non-voting common stock is tainted.

It would seem, however, that non-voting stock otherwise sharing in all the rights of the common and not subject to redemption should be considered as true common and not tainted. This type of stock is often useful in planning as where an individual wishes to give part of his business, for example, to a daughter who will not participate in management and part to a son who is intended to participate.

The forms of stock redemption just discussed generally result in dividend or exchange treatment to the shareholder depending upon his situation: how much ownership he gives up, how he acquired the stock being redeemed, and so on.

Partial Liquidation

If the redemption can be made to qualify as a partial liquidation, however, these matters are beside the point and the amount distributed will automatically be treated as payment in exchange for the stock redeemed.

A partial liquidation may be a step toward full liquidation. In other situations it contemplates that there has been a genuine contraction in the business so that some of the assets formerly needed can now be distributed. Not included would be distribution of a reserve for an expansion that did not take place.

Specifically included in the definition of a partial liquidation is a situation where the distribution is attributable to the discontinuance or the distribution of the assets of a business actively conducted for five years preceding the distribution. It is also necessary that the corporation retain another business which was also actively conducted during the five-year period. Neither of the businesses may have been acquired during the five-year period in a taxable transaction.

Two Treasury rulings on the question of what qualifies as a partial liquidation are of interest. In one case, a company engaged in the food brokerage business had leased some real estate to a used car dealer for five years. This rental property produced less than 2% of the gross income. Distribution of the rental property was held not to qualify. Rental of the small piece of land was considered as only incidental to the main business and its distribution was held not to fit the concept of contraction of the entire business.

In the second case, the corporation had three parcels of rental real estate and no other business. Two buildings had been held for more than five years while the third (and smallest) had been held for less than five years. One of the buildings held for more than five years was distributed to the stockholders in exchange for part of their stock. This distribution resulted in a partial liquidation. Each of the buildings held more than five years represented a business and termination by distribution of one business represented a genuine contraction.

This ruling is illustrative of the rule that distributions can be made in kind. If the property in question has substantially appreciated in value, it will ordinarily be advisable to distribute it in kind.

Property distributed in kind can include inventory. The regulations indicate that inventory of a business being terminated can only be distributed in partial liquidation to the extent that it is substantially the same in kind and quantity as that held during the previous five years. Presumably this rule is intended to prevent the indirect distribution of funds not attributable to the business being terminated by using them to increase the inventory shortly before distribution.

As to the final part of this discussion of stock redemptions, I should like to touch briefly upon some of the considerations applicable to individual shareholders of a company which is terminating its corporate existence and will distribute its assets in redemption of all its stock.

Complete Liquidation

There are three main alternatives under the heading of complete liquidation of a corporation owned by individuals.

The first is simply to distribute all the assets in redemption of all the stock. This course results taxwise in an exchange of the corporation's stock for the assets at fair market value. It leaves the assets in the hands of the former shareholders to use or dispose of as best they can.

The second alternative is to make a special election and distribute all the assets in redemption of all the stock within one calendar month. The general effect is that the stockholders will be taxed as though on a dividend on their gain to the extent of the accumulated earnings and profits and they will be taxed at capital gain rates on that part of the gain which is represented by money or recently acquired securities in excess of the accumulated earnings and profits. Any additional gain will not be recognized.

The third alternative is to have the corporation adopt a plan of liquidation and thereafter sell the assets and distribute the proceeds within a 12-month period. This method generally avoids corporate tax although permitting the corporation to dispose of the assets while allowing the shareholders exchange treatment on the redemption of their stock.

In choosing among these alternatives there are several factors to consider. The one-month liquidation with partial non-recognition of gain will rarely be advisable if accumulated earnings and profits are substantial because of treatment of a corresponding portion of the gain as a dividend. This choice will also rarely be made if the assets are to be disposed of because the remainder of the gain will be realized at that time. The principal application is to situations wherein the corporation has small accumulated earnings and profits but large unrealized appreciation in one or more of its assets. If the shareholders want to continue to hold the assets as individuals, the special election permits them to avoid tax on the transfer to themselves.

As between the other two alternatives, the problem arises when sale of the corporate assets is in prospect. Unless there is some planning, there is always the danger of two taxes one to the corporation when the assets are sold and a second to the stockholders upon liquidation. If sale by

the corporation will result in a loss, it will often be advisable to sustain this loss and then have a simple liquidation. In a gain situation, there will be only one tax if liquidation precedes the sale. However, it may be difficult, if there are many stockholders, to arrange a sale on their behalf. And, if any negotiations preceded the liquidation, there may always be a question as to whether the sale was actually made by the corporation or the stockholders.

The alternative of adopting a plan of liquidation, having the corporation sell the assets, and then liquidating all within a 12-month period generally avoids these problems. If there are both potential gains and potential losses, consideration may be given to sustaining the losses prior to adopting the plan of liquidation and realizing the gains thereafter. Ordinarily, the plan of liquidation is adopted on the date the shareholders adopt a resolution authorizing the distribution of all the assets in redemption of all the stock. The Treasury has contended—unsuccessfully in a recent case—that it is entitled to push this date back if there are previous loss sales that might be considered part of the over-all plan.

Because every stock redemption, in cases where the corporation has accumulated earnings and profits includes elements that might resemble a dividend, there are numerous provisions surrounding the subject designed to protect the revenue which can easily prove disastrous to the unwary taxpayer. There are few places where careful consideration before acting is of more importance.

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DEPRECIATION DEVELOPMENTS

By John F. Cerny

Useful Life, Salvage Value, Capital Gain

For many years, taxpayers have led a more or less peaceful coexistence with the Treasury Department on the meaning to be ascribed to the terms "useful life" and "salvage value." Before the 1954 Code was passed, it was generally believed that the term "useful life" had a meaning which described the whole physical life of the asset. "Useful life" meant the period of time required to use up assets in total employment in the economy rather than the time they were held by a particular taxpayer. Consistent with this interpretation, salvage value was traditionally understood to be equivalent to scrap value. In this sense, it is the amount realized when an asset is no longer suitable for its original use. Further, it is the value of the asset's basic materials when it is broken up for scrap.

It would seem to be a reasonable assumption that the Treasury Department acquiesced in these definitions with few exceptions. Such construction had wide acceptance among taxpayers. There were no official rulings to the contrary. Revenue agents rarely insisted on different interpretations. Congress also had not found it expedient to define useful life or salvage value in the law. In the 45 years of Federal income tax law, the allowance for depreciation is stated in the Code in simple terms as a reasonable allowance for the exhaustion, wear and tear of property used in a trade or business or held for the production of income.

The attitude of the Treasury Department has been one of tacit approval, but in recent years it has viewed with alarm the revenue loss resulting from the lower tax on gains from the disposal of depreciable assets. It brought this situation to the attention of the Ways and Means Committee of the House in 1947 and 1948, but Congress did not act. However, Congress did see fit to make an exception so that gains on sales of emergency facilities certified during the Korean War and thereafter are to be reported as ordinary income to the extent that amortization exceeds regular depreciation that would have been taken. No change was made in the treatment of gains as capital gains on sales of assets used in a trade or business.

Presumably, the Treasury Depart-

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ment's anxiety reached the frightening state with the enactment of the 1954 Code. Methods of depreciation were enacted into law which were specifically designed to allow taxpayers accelerated depreciation allowances. This aggravated the situation. Depreciation was now to be deducted from ordinary income at a faster rate, which would normally increase the gain taxable at capital gain rates.

When Congress considered the 1954 Internal Revenue Code, it did not see fit to change the long-standing definition of the allowance for depreciation. In fact, the Senate Finance Committee Report states that nothing in the new law is to be construed as limiting or reducing depreciation allowances considered reasonable under the 1939 Code. Inferentially, this could mean that Congress was satisfied with the treatment of useful life and salvage value as commonly understood under the 1939 Code.

During the hearings on the 1954 Act, the Committee on Federal Taxation of the American Institute of Certified Public Accountants recommended that gains on property used in a business be treated as ordinary income. Congress ignored this proposal. Instead, it visualized that the new liberal depreciation allowance would help maintain the present high level of investment in plant and equipment, increase working capita materially aid growing business i financing expansion, and encourag modernization and expansion of in dustrial capacity with resulting eco nomic growth, increased productio and a higher standard of living.

Perhaps the first announcement o a change in Treasury Departmen policy came in a letter appearing i the *Congressional Record* on June 1(1955, from Lorens Williams, assistan to the Secretary of the Treasury, t Representative Thomas B. Curtis o Missouri. This letter described de preciation allowances under the 195 Code as it applied to the purchase o a new automobile and the treatmen of gain on the subsequent sale of th car. It noted that there were loos statements being made in regard t an alleged loophole in the new meth ods of depreciation permitted by th Internal Revenue Code of 1954. I referred to statements appearing i a local newspaper column which use the following example: "A ric motorist, making $100,000 a yea buys a super duper motor car fo $4,600, for use in his business. H takes $2,300 of depreciation on th declining balance method, (50%) i the first year, then sells the car fo $3,400. Citing his tax specialist, th columnist made the following compu tation:

Income tax saved by $2,300 depreciation deduction		$2,00
Cash received on sale of car		3,40
Total cash		5,40
Cost of car	$4,600	
Capital gain tax on sale of car (25% of $1,100) ($3,400 − $2,300)	275	
		4,87
Net cash profit		$ 52

This letter is probably the Treasury Department's first clear pronouncement on definitions of salvage value and useful life. The principles enunciated in the letter have been incorporated in the final depreciation regulations under the 1954 Code. The following quotation from this letter refers to the aforementioned example.

"Such statements are based on several fallacious assumptions. In the first place, they ignore the salvage value of the property, erroneously assuming that depreciation may be taken on the whole cost of the property. Depreciation may be taken only on the difference between cost and salvage value. Moreover, assets may not be depreciated below a realistic salvage value. In determining realistic salvage value, consideration must be given to the taxpayer's use of the property, the retirement and maintenance practices he follows, and the salvage or other proceeds he realized on disposition of the property. Junk or scrap value may be used only where the taxpayer follows the practice of using depreciable property for its full serviceable life. Where a taxpayer's practice is to dispose of depreciable property substantially before the end of its full useful life, the realistic salvage value will be realized at time of disposition. Thus, in the example, depreciation would be allowable only on the difference between the car's cost ($4,600) and its salvage value ($3,400).

"In the second place, the allowable rate of depreciation is dependent on the useful life of the property, and the example erroneously ignores the fact that the useful life used in determining depreciation allowances is not the full, normally inherent useful life of the property. It is rather, the useful life of the property determined in accordance with the practice of the particular taxpayer in his trade or business or in the production of income. If a taxpayer has no consistent practice regarding the disposition of depreciable property, the estimated useful life of his depreciable assets should be determined in the light of experience in the taxpayer's business or industry."

These statements were a preview of what was to follow in the regulations adopted on June 11, 1956. The 1954 Code regulations incorporated the principles expressed in this letter.

Armed with this regulation, the Treasury Department has begun its attack. The results of its drive are being felt in the courts, not only for 1954 Code years but also for years under the 1939 Code. If the interpretations of useful life and salvage value mean what Treasury regulations state, such construction will severely restrict capital gains on the sale of depreciable assets.

In two recent cases covering pre-1954 Code years, the Treasury met with complete success. (Robley H. Evans v. Comm., 16 TCM 639, July 31, 1957; Bertrand W. Cohn v. U. S., 6th Cir., 58-2 USTC, 9840, Sept. 26, 1958.) In a third case covering 1954 Code years it suffered a set-back. (Hertz Corporation v. U. S., Dist. Court of Delaware, 58-2 USTC, 9720, July 17, 1958.) Although the Hertz case was victory for the taxpayer, the victory may be short lived.

In Evans, the taxpayer was engaged in the business of leasing automobiles to a drive-it-yourself agency. Depreciation was taken in the years 1950 and 1951 on the inherent useful life of the automobiles (four years) with no salvage value. The Treasury contended that depreciation should be computed on the basis of useful life

equal to the period the automobiles were retained by the taxpayer (15 months) with salvage value equal to an average sale price of 1,375. Evans' position was based on grounds that the terms useful life and salvage value have attained definite and fixed meanings under the 1939 Code; that useful life means physical or inherent functional life; that salvage value means residual, scrap or junk value after physical life has been exhausted. The Tax Court disregarded this theory entirely and in its opinion failed even to mention the argument of the taxpayer and wholly ignored the interpretation of law upon which he relied. Evans is currently on appeal in the Ninth Circuit.

In the Cohn case, the District Court and the 6th Circuit sustained a novel, if not dubious theory, that, in the last year of depreciation when assets are sold, salvage values may be adjusted to known sales prices in calculating depreciation for such year. This case involved the owners of three flying schools. Depreciation had been taken on various types of equipment over a four year period. The schools were organized in 1941 as a part of the war effort to train pilots for the Army Air Force under the Civilian Contract Flying Program. Taxpayers estimated that all depreciable equipment should be written off during a period of time which was to end on December 31, 1944. No salvage value was taken into account. Because of shortages of equipment at the time the schools were terminated in 1944, the taxpayers disposed of their equipment at extremely favorable prices.

The Treasury originally contended that the useful life of the equipment was considerably longer than the four years used by the taxpayers, but later agreed the four year life was correct. However, it insisted that a salvage value factor should have been take into account at or near the end of th useful life of the equipment.

The District and Circuit Cour agreed that when the assets were sol the salvage value must be measure by the known sales price. Conse quently, no depreciation could b taken in the last year since the cos remaining to be depreciated wa equal to or less than the actual sale prices. Even though this was a 193 Code case, the Circuit Court wen further and said that this same rul would apply under the 1954 Cod despite Treasury regulations to th contrary, which state, "Salvage valu shall not be changed at any time afte the determination made at the time o acquisition merely because of change in price levels." The Court noted th aforementioned sentence in the 195 Code Regulations but said that th Regulations also state "However, i there is a redetermination of usefu life . . . salvage value may be redeter mined based upon facts known at th time of such redetermination of use ful life."

It would seem that the Circui Court used a wrong premise to arriv at its conclusions. Both the Treasur and the taxpayers in the case ulti mately agreed that the life used i calculating depreciation was the lif used originally in filing the Federa income tax returns. There was no re determination of useful life. The co rect salvage value should have bee the amount which could have bee estimated in the first year of usefu life, not in the last year. It appear that the Court was searching for sal vage value figures consistent with th short useful life agreed to by the tax payers and Treasury. It disregarde testimony that industry practice wa to assign 10% of cost to salvage valu

and instead, used the sales prices of the assets sold.

The Hertz case is the first real test of the 1954 Code regulations on depreciation. Hertz Corporation took over the auto and truck rental and leasing firm of J. Frank Connor, Inc. in the middle of 1956. Connor had not used the accelerated depreciation methods for newly acquired cars and trucks, and Hertz filed a refund claim based on using the 200% declining balance method for the years ending March 31, 1954, 1955 and 1956 under the retroactive election then permitted by the regulations. The average holding period of the cars and trucks during the fiscal years in question was 26 months, and 38 months respectively. The three questions presented for the Court's consideration were (1) is the useful life of an automobile the period of its usefulness for business purposes, or only the period it is held by the taxpayer? (2) under the declining balance method of depreciation, shall salvage value (other than such salvage value as is inherent in the declining balance method) be imposed as a limitation upon the taking of depreciation under the method? and (3) may the Treasury regulations on depreciation under the 1954 Code be applied retroactively to periods prior to June 11, 1956, the date of promulgation of such regulations?

Connor computed depreciation generally by using a four-year life for automobiles and a four to five year life for trucks. The Treasury said that the automobiles had a useful life of less than three years since Connor had a practice of disposing of such cars before the end of three years. In determining useful life, the Treasury contended that Connor could not look to the inherent physical life of the assets but only to the useful life to him which was less than three years. Consequently, Connor was not entitled to declining balance depreciation and had to use straight-line. Further, the Treasury said that salvage value must be recognized under all methods of depreciation, that is, the estimated proceeds on disposition at the end of an asset's useful life in the taxpayer's hands. This procedure automatically eliminated capital gains on the sale of automobiles.

In the case of the trucks, the Treasury again cited 1954 Code Regulations, which provide that although the cost of an asset is not to be reduced by salvage value in computing depreciation under the declining balance method, the asset cannot be depreciated below salvage value.

The District Court said the Treasury's theories on economic useful life to the taxpayer were wrong for periods prior to promulgation of 1954 Code regulations. It said that the inherent physical life of the assets determines useful life for depreciation purposes under the 1939 Code and therefore the four-year life which Connor used was correct. It also said, that, under the declining balance method, salvage value is not to be taken into account at any time. The Court concluded that the regulations which state that depreciation must stop when salvage value is reached are invalid when applied to the declining balance method. It sustained Connor on the use of the declining balance method and allowed the capital gains on the sales. The District Court, however, went on to say that on and after the date of promulgation of 1954 Code regulations, namely, June 11, 1956, there is an administrative change in the definition of useful life. The new meaning is to be applied prospectively only. Useful life now means the length of time an asset will

probably be used by the particular taxpayer instead of its inherent physical life. The Treasury no doubt will appeal the Hertz decision.

It seems obvious that the purpose of the Treasury is to assert a new definition of useful life and salvage value and through this back door it hopes to reduce substantially capital gains from the sale of depreciable business assets. There is little doubt that arguments with revenue agents will increase in this area. The real question seems to be whether or not the Treasury Department can change long-standing and accepted practices in depreciation without a direct mandate from Congress.

Change from Declining Balance to Straight-Line Method

Taxpayers who regularly realize capital gains on sales of equipment and other assets are certain to face a challenge by the Treasury on the proper salvage value to be used in calculating depreciation. The conclusion reached in the Hertz case has brought into focus an apparent immunity of the declining balance method to the concepts of salvage value which are required to be considered when other methods of depreciation are used.

The Committee Reports on the 1954 Code show more than a casual mention of salvage value. The Senate Finance Committee Report states in clear terms that under the straight-line method and the sum of the years digits method the cost of an asset is to be reduced by estimated salvage value before applying the proper depreciation rate, but under the declining balance method "salvage value is not deducted from the basis prior to applying the rate, since under this method at the expiration of useful life there remains an undepreciated balance which represents salvage value." The Committee Report states further that the taxpayer may switch from the declining balance method to the straight-line method of computing depreciation at any time but " . . . the taxpayer must at the time of the change estimate a realistic salvage value and useful life."

The wording of the regulations certainly leaves no doubt that the expressions relating to salvage value in the Finance Committee Report have not been ignored. If the Hertz case is sustained on appeal, taxpayers faced with salvage value problems should use declining balance depreciation wherever possible to avoid arguments as to proper salvage value.

One of the features of the declining balance method is that a switch to the straight-line method can be made at any time during the life of the asset without permission of the Treasury. However, when the change is made to the straight-line method, a ruling issued in August, 1958 states that salvage value is to be taken into account and determined in accordance with the conditions existing at the date of the change. The rate used for depreciation is to be reviewed and, if appropriate, revised either upward or downward based on a realistic estimate of the remaining life of the property. This ruling should serve as adequate notice that any taxpayer who has a serious salvage value question and uses the declining balance method of depreciation should think twice before switching to the straight-line method.

The option to switch from the declining balance method to the straight-line method at any time in the life of the preperty is applicable only to new property acquired after 1953. It may be recalled that in August of 1957 the Treasury issued a ruling regard-

ing the use of the declining balance method of computing depreciation at a rate not in excess of 150% of the straight-line rate for new or used tangible property acquired prior to January 1, 1954, and used tangible property acquired after December 31, 1953. Briefly, this ruling gave Treasury blessing to the use of the 150% declining balance method. In order to change from the 150% declining balance method to the straight-line method, it is necessary to secure the consent of the Treasury prior to changing.

It seems likely that the 150% declining balance method on purchases of used property is as much subject to attack by the Treasury on the salvage value factor as the straight-line or sum of the years digits methods. There would appear to be no doubt that these factors should be thoroughly reviewed before permission is sought to change to the straight-line method.

Keeping Books for Purposes of Accelerated Depreciation

One of the requirements which must be met by those taxpayers who use accelerated depreciation methods for tax purposes but not for book or financial statement purposes is the maintenance of permanent auxiliary records with the regular books of account, reconciling all differences between depreciation for tax purposes and for book purposes resulting from methods of depreciation, basis, rates, salvage, or other factors. The Treasury has ruled that[1] "work sheets" are not acceptable because they are not permanent in nature. A permanent record is the minimum standard which the Treasury expects of taxpayers.

The Treasury is aware that in many instances the accountant has the only record of accelerated depreciation which he maintains for his client and which is kept in the office of the accountant. It apparently felt that this situation causes inconvenience and difficulties for examining agents. This circumstance probably prompted the ruling. If the taxpayer changes accountants between the time the return has been prepared and the time when the revenue agent comes in to make the examination, in many stances the agent may have to contact the former accountant for the reconciling data causing loss of time in examinations. The ruling places the responsibility of keeping the necessary record on the taxpayer. The agent ordinarily should not need any supplementary data other than that which is located on the taxpayer's premises in order to satisfy himself that depreciation has been properly computed because sales, trade-ins, and retirements increase the possibility of error. The Treasury wants a continuing reconciliation so that it can be satisfied that there has been no duplication of depreciation in tax returns.

Although neither ruling nor the regulations on depreciation describe the type of record that is required for this purpose, it would appear that "working papers" of the type prepared by an independent accountant during the course of an audit meet the Treasury's requirements, as long as such working papers or copies thereof are kept at the taxpayer's office. Further, if the taxpayer's working papers prepared in connection with the preparation of the return have sufficient detail to reconcile reserves for depreciation, such a record would probably satisfy the Treasury. It is fairly clear that, if the only record

[1] Revenue Ruling 58-306.

maintained is kept in the accountant's office, this will not constitute compliance with the Treasury's ruling.

Improvements on Leased Property

If a lessee makes improvements on leased property and the lease contains an option for renewal, taxpayers and the Treasury have argued for a great many years about the period over which the leasehold improvements should be amortized. Taxpayers are usually inclined to write off cost over the term of the original lease. The Treasury, however, usually looks at the term of the original lease plus renewal options in the original lease. The Courts have generally held that the period of amortization for the costs of a leasehold and of leasehold improvements made by a lessee under renewable lease should not include the renewal period unless the facts show with reasonable certainty that the lease will be renewed.

Regulations under the 1954 Code cite the following example of the test of reasonable certainty that a lease will be renewed. A subsidiary corporation leases land from a parent at a fair rental for a 25 year period. The subsidiary erects on this land factory buildings having a normal useful life of 50 years. These facts show with reasonable certainty that the lease will be renewed even though the lease contains no option of renewal. Therefore, the cost of the buildings shall be depreciated over the estimated useful life of the buildings in accordance with the regulations on depreciation.

The 1958 Act writes into the law certain rules for amortizing leasehold improvements and leasehold acquisition costs and does more to confuse rather than to clarify this problem. Arguments in this area are likely to continue. The rules are as follows:

If there are no options to renew in a lease, leasehold improvements should be amortized over the term of the lease or depreciated over its useful life, whichever is shorter.

Renewal options may be ignored if, when an improvement is completed, the remaining term of the lease is at least 60% of the useful life of the improvement. However, the renewal period may still have to be considered if the facts show reasonable certainty that the lease will be renewed. For example, the original term of a lease is for 15 years with a renewal option for an additional ten years. When the original lease has nine years to run, an improvement with a useful life of ten years is constructed. The remaining term of the lease is more than 60% of the useful life of the improvement. The renewal period can be ignored unless there is reasonable certainty that the lease will be renewed.

Renewal options may not be ignored if, when the improvement is completed, the then remaining term of the lease is less than 60% of the useful life of the improvement. However, if the taxpayer can show that it is more probable that the lease will not be renewed, the renewal period can be ignored.

Leasehold acquisition costs may be written off over the original term of the lease if at least 75% of the cost is attributable to the original lease term. The renewal period must be taken into account if less than 75% of lease acquisition cost is attributable to the original lease term. However, in either case, if the facts show that the lease will not be renewed, such costs may be written off over the original term of the lease. On the other hand, even if such costs are at least 75% attributable to the original term of the lease but the facts show reasonable certainty that the lease will be renewed, the renewal period cannot be

ignored. Can anything be more confusing than this?

If a lease is between related parties, for example a corporation and its 80% owned subsidiary, all leases are ignored. The improvement must be depreciated over its useful life.

These new rules apply to leasehold acquisition costs incurred after July 28, 1958 and to improvements begun after July 28, 1958 unless there was a pre-July 29, 1958 legal obligation to begin the improvements.

Problems on Additional First Year Depreciation Allowance

The 1958 Act added a new section to the 1954 Code which permits a first year depreciation allowance of 20% of the cost of tangible personal property having a useful life of six years or more. The total cost on which this depreciation may be claimed is limited to $10,000 or to $20,000 in case of a joint return. This allowance is not available to trusts. It is applicable to taxable years ending after June 30, 1958 and to property acquired by purchase after December 31, 1957. It is restricted to tangible personal property which includes furniture, fixtures, machinery and all types of equipment but does not include buildings. Property eligible may be new or used. Salvage value is to be disregarded in determining the costs on which the allowance is based. However, when computing regular depreciation on the balance, salvage value may have to be considered.

Cost does not include traded-in property. Thus, if a new machine is bought for $3,000 cash plus the trade-in of an old machine with a basis of $5,000, the 20% may be applied only to the $3,000. To avoid this result, it may be better to sell the used equipment and buy the replacement property for cash.

The first year depreciation allowance is not to be prorated from the date of purchase during the year to the end of the year. For example, if a machine costing $10,000 was purchased in December of 1958, the full 20% allowance of $2,000 may be claimed in 1958. However, a prerequisite to the allowance of a deduction is that the machine is in use before the close of the year and that depreciation is allowable in the same year.

Even though such depreciation is claimed, the taxpayer is entitled to use regular depreciation. Accelerated depreciation may be taken if it is new property. However, the cost of the property is reduced by the first year allowance before calculating regular or accelerated depreciation for the year and is prorated from the date of the purchase to the end of the year.

The Treasury has issued temporary regulations providing that, if a taxpayer wishes to deduct the first year depreciation allowance, he must attach a statement to his return for the year indicating his election to use this provision. The information required to be attached to the return is as follows:

1. Description of property.
2. Date acquired.
3. Estimated useful life at date of acquisition.
4. How and from whom acquired.
5. Total cost of each item of property with respect to which the election is made.
6. Proportionate cost of property selected.

If a taxpayer acquires several assets eligible under this provision, and the aggregate cost exceeds $10,000 or $20,000 in the case of a joint return, the taxpayer may select those assets on which the 20% deduction shall be

taken. Since the new law allows a choice, in almost every case it will be desirable to elect on the longest lived assets purchased during the year. The reason for selecting the longest lived assets is that it results in larger initial depreciation and a greater charge off in the early years of useful life than when shorter lived assets are chosen.

One of the unanswered questions in the new law is how this provision applies to partners and partnerships. Since a partnership is generally considered not to be a taxpayer but a conduit of income, the special depreciation allowance should, therefore, pass through the partnership to the partners. However, the election to take the 20% depreciation allowance is required to be made by the partnership. The $10,000 or $20,000 limitations, however, are imposed at the individual partner level.

Assuming a partnership composed of four equal partners, all married, it is possible that the partnership could elect to take 20% depreciation of up to $80,000 of partnership purchases of property which qualify. But suppose one of the partners is a partner in another firm which is also electing to take 20% depreciation on a full $20,000 allocable to him. Since the partner's deduction will be limited to $4,000 with respect to the first partnership, what happens to the $4,000 which was elected by the second partnership?

In partnerships where there may be many partners such as occur in oil drilling, real estate and theatrical ventures, the general partners may not know the marital status of each partner. If they assume that all partners are married and file joint returns, those who are not married and those who do not file joint returns could presumably lose by the election of the partnership to take the maximum amounts.

Where partners have unequal interest, a question arises as to whether the limitations apply to each partner's interest. For example, if a partnership had four partners whose interests are 10%, 10%, 10% and 70%, the firm might elect to take 20% depreciation on $80,000 because it had four married partners, but the 70% partner might lose part of his deduction since he would not be allowed to take first year depreciation on more than $20,000 of the $56,000 allocable to him.

The Treasury Department has tentatively decided to apply these limitations at the partner level and the partnership return instructions follow this decision. Although its decision may not be final, it says that it is much safer to assume at this time that the limitations will apply at the partner level than to assume that they will apply at the partnership level. Tentative thinking is that the regulations will provide that the partners may by agreement allocate the cost of the property among the members in any way they wish. In the absence of an agreement, however, the cost will be allocated in the profit and loss sharing ratio.

Burden Computation when Deduction for Amortization of Emergency Facilities is Taken

Depreciation is among the items of indirect expenses which the Treasury considers may be taken into account in valuing inventories. This depends primarily on accepted accounting practice. Under some circumstances it is excluded when it is considered to be of such a nature that it is incurred irrespective of degree of plant activity. The Treasury considers that the inclusion of such items as rent

repairs, taxes and depreciation in valuing inventories depends upon whether income is clearly reflected based upon (1) facts with respect to the degree of plant activity, (2) the extent of the natural relationship of the items to the goods produced, (3) whether such treatment conforms to the best accounting practice in the trade or business, (4) whether such treatment is consistent with past practices and (5) whether records are maintained which permit ready verification of inventory valuations.

In a very short ruling [2] published in April, 1958, the Treasury says that amortization of emergency facilities is not a part of inventory costs. This ruling states, however, that a taxpayer who, in accordance with accepted accounting practice, uses depreciation as part of inventory costs must also treat as part of inventory costs that portion of amortization of emergency facilities which is equal to the depreciation on the facilities that would have been included if the facilities had not been subject to amortization. Any amortization in excess of such depreciation constitutes a current allowable deduction from gross income. It states that this procedure permits income to be clearly reflected.

[2] Revenue Ruling 58-181.

Tax Aspects of Certain Dispositions of CPA's Practice

By Arthur O. Palm

The tax aspects discussed in this article are limited to the tax implications applicable to or stemming from the dispositions covered in the booklet issued in 1957 by The Illinois Society of Certified Public Accountants entitled "The Disposition of a CPA's Practice." That booklet covers only dispositions of a deceased practitioner's accounting practice or of his interest in a partnership conducting an accounting practice.

Disposition of an Accounting Practice Conducted as a Sole Proprietorship

Upon the death of the CPA conducting an accounting practice as a sole proprietorship, the estate or other successor in interest may merely wind up the aiffairs of the practice (bill for any unbilled services, collect accounts receivable, etc.) and liquidate the practice. A more satisfactory procedure may be to sell the practice to another practitioner or to an accounting partnership.

Liquidation of Decedent's Practice

A primary purpose of the booklet, to which this material is supplementary, is to assist the widow or others in preventing the type of "disposition" which will be discussed first, i.e., disposition by dissipation. This type of disposition results in an expiration of both the practitioner and the practice. The disposition generally will embrace and be limited to (1) billings and collections for services rendered prior to death by the decedent, (2) sale of tangible personal property (office furniture, office mechanical equipment, library, etc.) and (3) payment of expenses or other liabilities incurred by the decedent in his practice.

Federal income tax implications in this type of disposition are relatively simple. The final income tax return for the decedent will report only those items of income and expense includible therein under the method of accounting regularly used by the decedent in computing his income. All income applicable to uncollected fees not included as income of the decedent will be taxable to the estate or other person entitled, by reason of death of the decedent, to receive the income. Such income is taxable as ordinary income in the year received by the estate or other person. In the same manner, expenses in respect of the decedent's practice for which the decedent was liable, but which were not properly deductible for income tax purposes by

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the decedent under his regular method of accounting, are deductible for income tax purposes by the estate when paid or, if the estate is not liable, then by any other person having the right to receive the income or an interest in other property of the decedent.

As to the tangible personal property, the disposition thereof by the estate or other person entitled to receive the property generally will have no tax impact. The basis for determining gain or loss to the estate or other person receiving such property will be the fair market value at date of death (or one year from such date, if so elected). Inasmuch as the sale price of these assets, in most cases, will establish the fair value, no gain or loss will be recognized for income tax purposes. If for any reason it is unduly delayed so that a difference between valuation for estate tax purposes and ultimate sale price does exist, any gain or loss is capital gain or loss.

Sale of Decedent's Practice

Rather than merely liquidating the decedent's practice, a disposition by sale may take place.

The method of valuation used by the buyers or the seller is unimportant for purposes of this discussion, except to the extent applicable in the allocation of the price to the various assets.

The disposition of the practice may be consummated by (1) a fixed price with an outright cash payment, (2) a fixed price payable in installments or (3) a stipulated percentage of fees received or income earned by the successor practitioner. There are, of course, innumerable variations of these three basic methods; for example, a lump sum plus a percentage of subsequent fees or income, a percentage of subsequent fees or income with a stipulated minimum and maximum amount, and the like.

The sale may or may not include accounts receivable for services rendered by the decedent prior to his death. These accounts receivable usually will include amounts both billed and unbilled at date of death.

With respect to the seller, it is immaterial for income tax purposes (except for a matter of timing) whether accounts receivable and billable fees for services are sold to the successor or excluded from the sale and collected by the estate.

If the fees are collected by the estate, the tax implications are exactly the same as discussed previously in connection with a disposition by liquidation, namely, income applicable to the fees is taxable as ordinary income to the recipient in the year collected.

If the right to receive these same fees is transferred by sale to the buyer, then the seller has ordinary income equivalent in amount to that portion of the sale price which is allocable to such income but not less than the fair value thereof.

Inasmuch as the income collectible is indicative of the fair value and also represents the portion of the aggregate sale price fairly allocable to the right to such income, for practical purposes the income will be similar in character and equivalent in amount in either circumstance, but the year in which such income is taxed to the estate (or other person entitled to receive the income) would not necessarily be the same (date of sale may fall into a year different from date of ultimate collection if receivable is not sold).

As to the sale of all other assets by the estate (or other person entitled to receive such property by reason of

decedent's death) there will generally be no gain or loss for income tax purposes. The basis to the seller is fair market value at date of death of decedent (or one year thereafter if so elected). The sale price agreed upon between the seller and the buyer dealing at arms length in a situation of this kind generally is the only reliable measurement of fair market value. The sale of the decedent's accounting practice, of necessity, would need be consummated as shortly after date of death as possible. This being so, it follows that the sale price establishes the fair market value at date of death. This conclusion will not be affected by the terms of the sale, i.e., whether it be a fixed sum payable at once, a fixed sum payable in installments or an indeterminate price based on a percentage of the successor's fees or income. The only area of possible controversy would be the factual question of a proper segregation of the proceeds between the portion allocable to "income of the decedent" and sale of the remaining assets.

Disposition of an Interest in Partnership Conducting an Accounting Practice

If the decedent was a partner in an accounting firm rather than a sole practitioner, the estate or other successor in interest has several alternative possibilities of disposition of the deceased partner's interest: (1) sale to other partners, (2) sale to a third party or (3) sale to the partnership.

A sale to the partnership is considered to be a liquidation of the partner's interest by the partnership and is governed by specific provisions of tax law. A sale, whether to other partners or to a third party, is governed by different rules.

Despite the fact that, in many respects, the income tax implications are the same whether a sale is made or a liquidation is effected, in the interest of minimizing complexity in a quite complex area of taxation these two general categories will be discussed separately.

Death Followed by Sale of Decedent's Partnership Interest—Effect on Taxable Years

For income tax purposes, the taxable year of the partnership as to both the decedent partner and the surviving partner or partners is not affected by the death of a partner. This is not true in the event of a sale of a partnership interest. As to the partner whose interest is sold, a sale closes the partnership year on the date of sale. For the remaining partners the year continues to its regular closing unless the sale involves an interest of 50% or more in partnership profits and capital. Sale of a 50% or greater interest terminates the partnership and the partnership taxable year closes for all partners.

Bearing in mind that the closing date of a partnership's taxable year determines when the distributable income of such partnership becomes taxable to the partners, the following highlighted observations may be made:

(A) The final return of the decedent partner will not include any portion of the partnership income for the partnership taxable year in which death occurs. This remains the rule despite the fact that the decedent partner had withdrawn any or all profits earned to date of death. For example, assume partnership ABC and its three partners are on a calendar year basis. Partner A dies on November 30 to which date A's distributable share of partnership income is $18,000 of which he has withdrawn $15,000. A's final return will not include any part of the $18,000 distributable income despite the fact that he has withdrawn five-sixths there-

of. There is one exception to the foregoing general rule. If an agreement providing for the sale of the decedent partner's interest to the remaining partners immediately upon death is in effect, then, by reason of a sale rather than by reason of death, a closing of the partnership taxable year for the decedent would take place and his final return would include the $18,000 as taxable income.

(B) Decedent's share of distributable income of the partnership to date of death is "income in respect of the decedent" and is taxed to the decedent's estate or other successor in interest when "received." The regulations in respect to decedent's distributive share of income to date of death appear to create an anomally as to the income withdrawn by the partner prior to death. Distributive income is not taxed to the partner despite his withdrawal of such income but rather is "income in respect of a decedent" and is taxed to his estate or other successor in interest "when received." Insasmuch as the amount of profit withdrawn by the partner will not be available again for distribution to the estate, it would appear that the incidence of taxability ("when received.") will never occur.

(C) Decedent's estate or other successor in interest may or may not share in profits or losses of the partnership during the interim between date of death and date of sale. This is governed entirely by the partnership agreement. If the agreement does provide for such sharing, then the estate or other successor in interest will have distributable taxable income reportable for the period from date of death to date of sale. If the regular partnership taxable year closes prior to such sale, the estate or other successor will have two periods for which partnership income or loss must be reported: the first from date of death to date of close of partnership's taxable year, and the second from the beginning of the next partnership taxable year to date of sale of the decedent's interest.

An area to which the regulations contribute ambiguity rather than clarity relates to the effect of the death of one partner in a two-man partnership. Ordinarily the partnership terminates when the accounting practice is no longer carried on in partnership or when 50% or more of the total interest in profits and capital is sold or exchanged. In the event of death of one partner in a two-man equal partnership, the ultimate sale of the decedent partner's interest definitely terminates the partnership. However, as to the interim period from date of death to date of sale, the status of the partnership is less definite in certain respects. The applicable regulations state that the partnership does not terminate if the decedent's estate or other successor in interest continues to share in the profits or losses of the partnership business, leaving the inference that, in the absence of such sharing, the estate or other successor in interest is not considered as a partner and as result thereof the partnership does terminate at date of death. This termination would close the partnership taxable year at the moment of death and all distributive income of the partnership to that date would be included in the decedent's final return. However, in other parts of the regulations it is provided that a termination does not take place so long as the decedent's estate or other successor holds an unliquidated interest in the partnership.

While neither the law nor the regulations so provide, it would appear that death of one partner in a two-man partnership does not of itself close the partnership taxable year. The closing of the year will hinge rather on a "termination" date which will take place upon ultimate sale or liquidation of the decedent's interest.

The effect of death of a partner and the subsequent sale of his partnership interest on the closing of the partnership taxable year is of importance only because it determines (1) the

year of taxability and (2) the taxpayer to whom partnership income is taxed. Closing the taxable year of the partnership at date of death may tend to pyramid income into the decedent's last return. On the other hand, deferring the closing beyond date of death may be a serious disadvantage due to loss of benefits of income splitting in a joint return (unless surviving spouse qualifies for continuance of income splitting for the two years subsequent to death of decedent). In addition it may result in the deductions being in decedent's last return with the otherwise offsetting income being in the income tax return of the decedent's estate or other successor in interest. Much can be done by way of (1) proper partnership agreements, (2) timing the sale of decedent's interest, (2) distribution of income from the estate to the beneficiaries, etc., in order to alleviate any undue hardships and ameliorate the tax impact, but this can be done only by study of each individual situation and not by broad general tax planning.

Death Followed by Sale of Decedent's Partnership Interest — Character of Income to Estate or Other Successor in Interest

Death terminates the partner's existence as a taxpayer and a new taxable entity, the decedent's estate, comes into existence at date of death.

At that time not only do property rights but income rights also pass to the decedent's estate or other successor in interest.

As has been previously noted, the income or rights to income of the decedent not taxed to the decedent, when collected or sold, ordinarily will be taxed to the estate or other successor in interest.

As to the decedent's share of reportable partnership income to date of death, the estate or other successor in interest will have ordinary income when collected or, if the right to receive such income is sold, then upon such sale.

In tax parlance this income is known as "income in respect of decedents" and is governed by specific provisions of the tax law.

In determining the amount of "income in respect of decedents" of a deceased partner taxable to the estate, a question arises as to whether so called "unrealized income" originating from services of the partnership during the decedent's lifetime, but which as a result of the method of accounting used by the partnership is not included in income of the partnership, must be included.

There are specific provisions in the law and regulations dealing with this question in connection with the liquidation of a deceased partner's interest (discussed later), but as to a sale of such interest by the estate or other successor in interest the law and regulations are silent.

If the estate or other successor in interest is considered to be a partner for federal income tax purposes, then the provisions covering the sale of an interest by a partner would be applicable. These provisions of the 1954 Code (Section 751) compel the selling partner to recognize as ordinary income the income from the sale of his interest in this "unrealized" income of the partnership.

Unfortunately, again the law and regulations are quite explicit regarding the estate's status as a partner in a liquidation of a deceased partner's interest (also discussed later) but silent as to such status in connection with a sale of the interest.

Despite the lack of a specific provision in connection with this some-

times troublesome question, it appears that unrealized receivables of the partnership are taxed as "income in respect of a decedent" when collected by the estate or other successor in interest (not including a successor who has status of a partner) regardless of the mode of collection, i.e., (1) by liquidating payments received from a partnership, (2) by sale of the decedent's interest in a partnership, or (3) by sale of a sole practitioner's unbilled fees.

As to the remainder of the decedent's interest at date of death (other than share of distributable earnings to date of death and unrealized earnings originating from services performed prior to date of death), any gain or loss on sale or exchange thereof will be capital gain or loss. However, inasmuch as the sale thereof will generally take place shortly after date of death, the sale price usually establishes the fair market value at date of death (or one year thereafter if so elected) which in turn becomes the seller's basis and no gain or loss is realized. As in the case of the sale of the sole practitioner's practice, this conclusion is not affected by terms of sale, i.e., whether it be a fixed amount or an indeterminate amount. The only area of controversy would be the factual question of determining the portion of the proceeds attributable to "income in respect of the decedent."

Death Followed by Liquidation of Deceased Partner's Interest

Perhaps the most generally used method of disposing of a deceased partner's interest in a partnership is, in effect, a sale of such interest to the partnership itself. This involves a distribution of money by the partnership in liquidation of the deceased partner's interest. Such a liquidation may be provided for in the partnership agreement or negotiated by the estate or other successor in interest after the partner's death.

Death followed by a liquidation of the deceased partner's interest does not affect the closing of the partnership taxable year either as to the partnership, surviving partners, or deceased partners until such liquidation is complete and then only if the partnership was a two-man partnership, in which event the partnership terminates on the day the last payment in liquidation is made.

During the period of liquidation, the deceased partner's estate or other successor in interest is treated as a partner.

The law and regulations presently in effect recognize that payments made to the deceased partner's estate or other successor in interest may represent payment for several different items. As to a partnership engaged in the accounting profession, these several items generally fall into two categories. The aggregate of the payments received in liquidation of the decedent's interest will cover the deceased partner's share of (1) the fair market value at the time of death of all assets of the partnership and (2) a share of the income of the partnership.

Payments attributable to the second category are taxed to the estate or other successor in interest as ordinary income in the same manner as regular distributable income of a partnership. However, by statutory concept the amount of the aggregate payments attributable to this category may actually include payment for an interest in assets of the partnership. For example, payment for decedent's interest in "unrealized receivables" of the partnership is never treated as a payment for his interest in assets but

arbitrarily is considered as a distribution of income.

"Unrealized receivables" is a legislatively enacted term and may, for the purpose of this discussion, be defined as rights to collect fees for services rendered by the partnership which, under the method of accounting used by the partnership, were not includible in taxable income of such partnership to date of deceased partner's death. This treatment for tax purposes is logical and fair and is necessary in order to prevent the conversion of deferred ordinary income into capital gain.

Another asset which may shift its character in this connection is goodwill of the partnership. Payments for goodwill which are in excess of the deceased partner's share of the cost basis to the partnership for such goodwill will be arbitrarily reclassified from a payment for an interest in assets to a distribution of partnership income except to the extent that the partnership agreements provide for a reasonable payment for such goodwill. The question of whether or not goodwill of a professional partnership is a saleable item has long been a controversial one and may well preclude any amount being sustained as reasonable.

Restated simply, the payments received by the estate or other successor in interest are classified as being in exchange for the deceased partner's share of the partnership assets and as a distributive share of partnership profits.

As to the payments for the interest in assets, no deduction from taxable income is allowed to the partnership or the surviving partners. Inasmuch as the law provides that the aggregate of these payments may not exceed the fair market value of the decedent's interest in partnership assets at date of death, generally no gain will result (fair market value is basis to the estate or other successor in interest). To the extent such payments are less than the fair market value, capital loss will result.

All other payments will be considered as attributable to distributive income of the partnership, will be taxed as ordinary income to the estate or other recipient, and will be deductible from partnership income in computing the distributable shares of income taxable to the surviving partners.

It is readily apparent that the surviving partners and the decedent's estate or other successor in interest have a divergence of interests in the character of the liquidation payments. Payments attributable to assets are generally tax free to the estate or other successor in interest. However, despite the fact that these payments may be made from current years earnings of the partnership, no deduction is allowed in determining taxable income of the partnership taxable to the surviving partners. On the other hand, payments to the decedent's estate or other successor in interest which are treated as distributable income of the partnership and taxed as ordinary income, in turn reduce, dollar for dollar, the taxable income of the surviving partners.

As a result of this adverse or conflicting interest of the survivors and the decedent, the government allows almost unlimited latitude to partners in allocating the liquidating payments to assets or income; the one exception is that the allocation to assets cannot exceed the fair market value of such assets at date of death.

In the absence of an agreement between all the partners prior to decedent's death or in the absence of any agreement as to allocation reached

by all the surviving partners and the decedent's successor, the regulations provide rules for such allocation.

Briefly, the rules provide that payments are to be allocated first to payments for the decedent's interest in assets (limited to fair market value at date of death) and the remainder treated as ordinary income. If the aggregate amount to be received is not fixed but, for example, represents a certain percentage of future profits for one or more years, all payments received are first treated as in exchange for decedent's interest in assets until the aggregate amount of such payments equals the fair market value of the decedent's share of such assets at date of death; thereafter all payments will be taxed as ordinary income. If the payments are fixed in amount for a fixed number of years, a pro rata part of each payment will be allocated to the total value of the interest in assets and the remainder will be treated as ordinary income.

Estate Tax Implications

The inheritance or estate tax is assessed on the "value" of the estate in excess of certain statutory minimum amounts. For example, as to a widow, no Illinois inheritance tax is payable on property inherited from her husband until the value of the inheritance exceeds $20,000. For federal estate tax purposes the statutory exemption is $60,000. Further, the theory of communal ownership applied to husbands and wives as to income earned by either spouse and gifts made by one or the other is applied also in the area of federal estate taxation by the use of the so-called "marital deduction." Stated in simple terms, any part of the decedent's estate which is inherited by the decedent's spouse, not in excess of 50% of the net estate, is considered, in effect, as an inheritance of that in which she already had a common interest, and no estate tax is applicable thereto. Thus, the marital deduction may effectively increase the $60,000 statutory minimum to $120,000.

No attempt will be made to discuss these taxes except as to the special problem applicable to the subject of this paper.

Valuation of the estate for estate tax purposes includes the fair market value of both rights to property and rights to income. For federal income tax purposes, rights to income owned by the decedent at the date of death are generally considered as "income in respect of the decedent" and taxed to decedent's estate or other successor in interest when collected. As a result, the combined estate tax and income tax on the same income could result in aggregate taxes (income and estate) thereon in excess of the amount of income involved. This hardship of double taxation is lessened in intensity somewhat by allowing as a deduction in computing the income tax that portion of the estate tax considered as attributable to the inclusion of the decedent's right to receive such income.

In this respect some confusion existed under the 1939 Internal Revenue Code in those situations where the deceased partner's estate or other successor in interest was to receive a share of income of the partnership earned subsequent to decedent's death. A Supreme Court decision covering this controversial area under such prior law apparently was interpreted generally as rejecting any evaluation of this right to the "future income" of the partnership, although, on the other hand, certain

subsequent lower court decisions distinguished the Supreme Court's case and held such right to future income includable in the gross estate.

The 1954 Code did not change the estate tax law in this respect, but provisions of the 1954 Code dealing with the income taxation of partnerships and decedent partners definitely indicate an intent to include the rights to such future income in the gross estate of the decedents. Further clarification as to the estate tax status of these payments is needed and no doubt will be furnished by future litigation.

A REEXAMINATION OF ON-JOB STAFF TRAINING

By Herbert Witt

The Report of the Commission on Standards and Experience for Certified Public Accountants has stimulated considerable interest on the part of the accounting profession. From the viewpoint of some, an excessive reliance has been placed on education rather than experience as required qualifications for the CPA certificate.

In this regard, it is interesting to examine some comments made by J. S. Seidman and Richard S. Claire in the Statements of Dissent to the Report, " . . . To substitute added schooling for experience is to make topsy-turvy of the wisdom of the past. Instead of recognizing experience as the best teacher, it regards a teacher as the best experience. It ignores the many shortcomings of the classroom that the Commission report so clearly describes (pp. 76–77).

"We have a profound respect for schooling. We think extensive education is a prerequisite to modern practice. But no matter how closely classrooms may try to simulate reality, they do not and cannot reproduce genuine accounting life. For example, it is only in actual engagements that there is opportunity to observe, if not experience, the workings of time pressures, client pressures, and the many other forces that give trial and meaning to 'objectivity' and 'independence'—the mainstays of our profession. . . .

"Experience, just like education, needs to be appraised qualitatively. That merely presents a challenge to some good hard thinking and the evolution of standards. A start in that direction would be to require employing accountants to describe the variety and calibre of experience afforded the applicant. They should also be asked to attest whether the applicant has sufficiently grasped and benefited from the experience to justify counting it toward the requirement for the CPA certificate. . . . "[1]

In considering these comments, the problems of making a qualitative appraisal of experience come to mind. What are the standards for satisfactory experience for staff members? How well do the practices of my firm meet these standards? What can the public accounting profession do to improve the experience and training which are given staff members?

As an aid to solving some of these problems, an attempt is made in the

[1] "Standards of Education and Experience for CPAs," University of Michigan, 1956; pp. 144–6.

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following paragraphs to analyze the components of on-job staff training. The major practices or elements of on-job training are discussed as a basis for reexamination by the accountant of practices within his firm. The development of an effective on-job training program will insure the opportunity for employees to obtain the needed experience for becoming worthy members of the profession. In this regard, we might refer to some comments made in *Generally Accepted Auditing Standards*, " . . . In order to qualify himself to carry out his functions, the independent certified public accountant has completed a rigorous course of professional study and training as a background to the essential practical experience he must obtain, for it is only by study, training, and practical experience that the independent auditor acquires skill in accounting and related matters." [2]

Formulating Individual Training Objectives

The importance of setting individual training objectives cannot be overemphasized. As one writer stated in discussing the problem of how we train, " . . . There seems to be no substitute for a first step in the process: the leader must conceive, as clearly as possible, his objectives with respect to his subordinates. Just exactly what is it that he would like to have changed? There is little room for vague generalities here. The leader must ask himself searchingly and examine the work situation carefully for the areas and the items where change is needed, and he must conceive as explicitly as possible the kind of situation he is aiming at after the change." [3]

In setting training objectives, individual differences must necessarily be recognized. Employees generally have varied educational and experience backgrounds, and different capacities, or learning curves, in their ability to benefit from specific experience. Training objectives should thus be set for each auditor based on individual needs, as well as needs of the firm. These objectives should not be static but should be changed in accordance with progress made by the employee during the course of his various assignments.

Planning Audit Assignments

Whenever practicable, assignments should not be made on a piecemeal basis, but in accordance with a plan which results in the continuing development of the auditor as well as in timely completion of audits. Often this cannot be done because of the exigencies of workload; we are all familiar with rush assignments and the problem of obtaining personnel to perform them. However, much can be accomplished by a deliberate intent on the part of supervisors to make assignments purposeful.

The assignment of an auditor to different supervisors may present difficulties in planning. Unless each supervisor becomes familiar with the manner in which the auditor has performed in the past and the areas in which he needs improvement, the benefits from an assignment may be lessened. A review of prior performance appraisals and discussion with other staff members will provide the supervisor with information which

[2] *Generally Accepted Auditing Standards*; American Institute of Accountants, N. Y., 1954, p. 16.

[3] Mason Haire, *Psychology in Management*, McGraw-Hill Book Company, Inc., N. Y., 1956, p. 118.

will assist in carrying out the audit assignment as well as training.

Diversification of Audit Assignments

The development of a staff member into a top-flight senior or manager requires training in the ability to handle increasingly more complex problems. It is through diversification of audit assignments that the staff member becomes familiar with problems in the audit of various parts of a business whole. The auditor who has worked for a year on the audit of cash accounts and vouching of fixed asset additions, for example, is not going to obtain more than a specialized knowledge of these areas. On the other hand, the auditor who has been assigned to audit of various balance sheet accounts on a planned basis over a period of time will have a better opportunity to obtain the wide experience needed to become a senior auditor.

Periodic Appraisal of Performance

Performance appraisals serve to inform various levels of management and supervisors as to abilities of staff members and what they are accomplishing. They also serve as a useful tool in staff training through:

a. Requirement for periodic appraisal and documentation of significant strength and weaknesses.

b. Basis for determining eligibility of the staff member for promotion, or needs for development to enable him to get a promotion.

c. Aid to outlining basic training needs and planning methods of improving performance.

d. Aid to counseling employee as to his ability in meeting performance standards.

e. Basis for evaluation and comparison with performance of other staff members of similar level to determine potential with the firm.

The value of the performance appraisals can be significantly increased with (1) proper instruction given to supervisors on how to fill them out, including the importance of "full disclosure" as a guiding principle; (2) proper counseling; (3) development of understanding by staff that criticisms shown on appraisals are constructive in nature and are used as a basis for providing developmental opportunities; (4) use as a basis for determining trends, such as that auditor is reaching a plateau; and (5) use in assignment of personnel to specific audit jobs.

Supervision and Job Instruction

There are many opportunities for the supervising auditor to aid in on-job training in the course of planning, organizing, controlling and reviewing the performance of audit assignments. In the "Duties of the Senior Accountant" section of the *CPA Handbook*, it is stated, "The senior should always bear in mind that he is responsible for the field training of the juniors assigned to him. This duty is overlooked easily in the pressure of an examination when the senior's time is taken up with seemingly more important matters. He should realize that his own position with the firm is strengthened when he contributes materially to the training of his assistants. Training will take several forms, such as instruction, supervision, demonstration, encouragement, criticism, and advice.

"Instruction should be given on the procedures to be taken, how to approach the work, how much to do,

what to look for, and how to do it. Instructions on irregularities will cover what kind to expect, how to recognize them, and which should be reported to the senior immediately. Instructions should be given on the form and content of the working paper schedules, the notations to be made as to the source of the information, the oral information obtained and from whom it was obtained. . ."[4]

In general, the method of giving instruction to subordinates plays an important part in on-job training. Communication of objectives down through the organization is very important, such as by explaining the meaning and purpose of the work to be undertaken. Specific assignments should be related to the over-all audit program. The subordinate should thoroughly understand instructions given. Supervised study of prior years' reports and workpapers, or workpapers prepared on similar audits, will assist the auditor in his development.

Counseling

The importance of counseling must be emphasized as a device for augmenting and strengthening the learning process in on-job training. An effective counseling program helps to point out an individual's weaknesses and suggest ways to correct them. Counseling serves to obtain the staff member's viewpoint, and thus furthers his participation in shaping his own training program. It may also assist in the staff member's personal adjustment to the firm's work practices and personnel.

The importance of counseling is emphasized in this statement of elements in coaching, or the process by which superiors get things done through subordinates.

1. "Subordinates must be given opportunities to perform.

2. "The superior must counsel subordinates, using the work situation as framework for counseling.

3. "The superior must develop team spirit among his subordinates and provide motivation.

4. "The relationship between superior and subordinates must be characterized as one of mutual confidence, a climate of confidence.

5: "The superior must set the standards of performance."[5]

Providing Opportunities for Leadership Training

The personal development of the auditor is an important element of on-job training. The ability to get along well with others should be emphasized. The ability to talk intelligently and sell his ideas is important. Effective leadership of subordinates is also an integral part of his development.

There are many opportunities for the supervisor to develop these traits on the job. The staff member should be encouraged to express himself in various job situations. He should be encouraged to participate in discussions with the client and with his superiors. He should be stimulated to arrive at independent decisions and gather sufficient evidence to support his position. His ability to plan, organize and control the work of subordinates should be emphasized, including the ability to get along with his men.

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[4] J. C. Martin, "Duties of the Senior Accountant," *CPA Handbook*, American Institute of Accountants, N. Y., 1953, pp. 112–13.

[5] Myles L. Mace, *The Growth and Development of Executives*, The Andover Press, Ltd., Andover, Mass. (1955), p. 193.

Conclusions

The major elements of on-job training have been summarized as a basis for improvement of existing firm procedures in providing useful experience for staff members. The summary facilitates setting up specific goals which the firm can strive for, through pinpointing significant areas for training. These elements of on-job training are not independent, but should be integrated by the firm into a comprehensive training program to meet the firm's needs.

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(Addresses are in Chicago unless otherwise indicated)

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Prudential Plaza (1)

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Arthur Young & Company
1 N. LaSalle Street (2)

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State of Illinois
Department of Revenue
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Henkel & Fox
300 W. Washignton Street (6)

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Arthur Andersen & Co.
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Office of Secretary of State
State of Illinois
Springfield, Illinois

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University of Illinois
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Elkhart, Indiana

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Bradley University
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